

China Lesso [2128.HK]

Decent 2014 Results; Low Oil Price to Pose Earnings Risk in 2015

China Lesso reported a recurring net profit growth of 16% year-on-year (YoY), excluding FX loss and one-off expenses related to early redemption of senior notes. Although we raise our FY15E/FY16E EPS by 8%/3% to reflect the better-than-expected 2014 results, we maintain our view that there is potential earnings risk this year as gross profit per tonne is likely to decline due to the cost-plus pricing mechanism amid weak raw material prices. We project 2015E recurring EPS to drop 8% YoY. We keep our target PER of 7.4x 2015E PER (15% discount to the five-year average), which is equivalent to HK\$4.45 (previous: HK\$4.20). Maintain HOLD. We will keep an eye on oil prices trend and review our rating if necessary.

Investment Highlights

- 2H14 recurring EPS grew 28% to RMB0.31.** Solid earnings growth in 2H14 was driven by (i) gross margin rose to 26.2% in 2H14, from 24% in 2H13, due to some time lags between the decline of raw material prices and that of average selling price (ASP); (ii) effective tax rate fell from 18% in 2H13 to 15% in 2H14, due to write-back of over-provided dividend withholding tax in previous years; (iii) revenue growth of 11.7% on the back of 10.1% volume growth. (see next page for a summary table)
- Low oil prices dragged raw material prices.** As we explained in the note dated January 30, China Lesso usually set the prices of its plastic pipe products based on a percentage margin above its production cost. As such, when raw material costs come down sharply, its gross profit per tonne will decline based on this pricing mechanism. As average Brent crude prices year-to-date (YTD) is 30% below the average price in Q4 2014, it dragged the prices of oil-related raw materials such as HDPE (High-density polyethylene), PP (polypropylene) and PVC (ethylene process).
- Gross profit per tonne may face pressure later this year.** As the company's PVC materials are produced by calcium carbide process (not ethylene process), its PVC cost is usually linked with coal prices. But a sharp fall of PVC (ethylene process) dragged the price of PVC produced by calcium carbide process. Average price of PVC produced by calcium carbide process YTD was 13% below the average price in Q4 2013. As the company did not initiate major ASP adjustment in January and February due to the Chinese New Year, we believe profitability in Q1 should remain strong (but relatively low volume due to the holidays). Given the high transparency of PVC, HDPE and PP prices, we expect more and more customers will ask for lower pipe prices soon. The company should be able to maintain its track record of keeping gross margin at around 25% but we project gross profit per tonne to drop 11% in 2015E if oil prices stay at a low level. (more on next page)

Y/E Dec 31	2011	2012	2013	2014	2015E	2016E
Turnover (RMB m)	10,143	10,891	13,071	14,823	15,184	16,455
Recurring net profit (RMB m)	1,184	1,219	1,405	1,653	1,516	1,642
Net margin (%)	12	11	11	11	10	10
Recurring EPS (RMB)	0.39	0.40	0.46	0.53	0.49	0.53
% Change	4	2	14	16	(8)	8
PER (x)	8.1	7.8	6.7	5.7	6.3	5.8
PBR (x)	1.9	1.6	1.3	1.1	1.0	0.9
EV/EBITDA (x)	5.5	5.2	4.3	3.8	3.9	3.5

Sources: Company, CGIHK Research

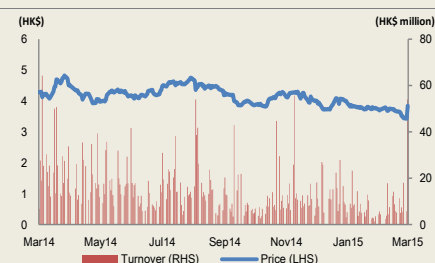
China Construction Sector

HOLD

Close: HK\$3.85 (March 17, 2015)

Target Price: HK\$4.45 (+15.5%)

Price Performance



Market Cap	US\$1,524m
Shares Outstanding	3,110.3m
Auditor	Ernst & Young
Free Float	31.6%
52W range	HK\$3.41-4.88
3M average daily T/O	US\$1.33m
Major Shareholding	Wong Luen Hei (68.1%)

Sources: Company, Bloomberg

Wong Chi Man--Head of Research

(852) 3698 6317

cmwong@chinastock.com.hk

Other takeaways in the analyst briefing yesterday:

- Management did not offer any specific guidance on volume growth but expect a “stable” growth.
- Capex for 2015 will be about RMB1.1bn. Capacity will expand by 100K-150K tonnes from 2m tonnes at end-2014. Aims to raise utilization rate to 80% (2014: 75.7%).
- Property-related sales contribution stood at about 30%+, largely stable. Management agreed market outlook this year would still be uncertain in the property sector.
- Dividend policy may remain conservative this year but management is considering high-per payout ratio post-2015 with a net cash position now.
- Tax rate dropped from 19% in 2013 to 16% in 2014 due to write-back of over-provided dividend withholding tax in previous years. Tax rate is expected to be back to normal (18%) this year.
- R&D expenses rose 87% YoY to RMB440m due to opening of some new R&D centres.

2014 Results highlights

(RMB'000, except for per share amount)

Year ended 31 Dec	2H 2013	2H 2014	YoY change (%)	Year ended 31 Dec	2013	2014	YoY change (%)
PVC pipes	4,520,930	4,821,458	6.6	PVC pipes	8,048,970	8,819,261	9.6
Non-PVC pipes	2,317,179	2,785,958	20.2	Non-PVC pipes	4,166,130	4,913,966	18.0
Others	540,215	634,305	17.4	Others	855,447	1,089,545	27.4
Revenue	7,378,324	8,241,721	11.7	Revenue	13,070,547	14,822,772	13.4
COGS	(5,604,610)	(6,084,006)	8.6	COGS	(9,804,979)	(11,022,038)	12.4
Gross profit	1,773,714	2,157,715	21.6	Gross profit	3,265,568	3,800,734	16.4
Operating expenses	(848,247)	(1,046,303)	23.3	Operating expenses	(1,502,919)	(1,830,806)	21.8
Operating profit	925,467	1,111,412	20.1	Operating profit	1,762,649	1,969,928	11.8
Other income and gains	46,606	47,984	3.0	Other income and gains	88,399	79,738	-9.8
EBIT	972,073	1,159,396	19.3	EBIT	1,851,048	2,049,666	10.7
Net finance costs	(64,776)	(36,038)	(44.4)	Net finance costs	(127,936)	(103,923)	-18.8
Profits from associates and JCEs	176	196	11.4	Profits from associates and JCEs	390	398	2.1
Non-recurrent items	19,700	(37,983)	n.a.	Non-recurrent items	44,009	(99,348)	n.a.
Income before tax	927,173	1,085,571	17.1	Income before tax	1,767,511	1,846,793	4.5
Income tax expense	(167,214)	(166,879)	(0.2)	Income tax expense	(329,895)	(306,435)	-7.1
Minority interests	6,568	7,797	18.7	Minority interests	11,645	13,666	17.4
Net income	766,527	926,489	20.9	Net income	1,449,261	1,554,024	7.2
Recurring net income	746,827	964,472	29.1	Recurring net income	1,405,252	1,653,372	17.7
EPS (RMB)	0.249	0.298	19.5	EPS (RMB)	0.471	0.500	6.0
Recurring EPS (RMB)	0.243	0.310	27.7	Recurring EPS (RMB)	0.457	0.532	16.4
DPS (HK\$)	0.120	0.130	8.3	DPS (HK\$)	0.120	0.130	8.3
Sales volume (tonnes)	716,257	788,621	10.1	Sales volume (tonnes)	1,272,631	1,431,639	12.5
PVC	564,114	617,220	9.4	PVC	1,003,362	1,125,911	12.2
Non-PVC	152,143	171,401	12.7	Non-PVC	269,269	305,728	13.5
ASP per tonne (RMB)	9,547	9,647	1.0	ASP per tonne (RMB)	9,598	9,593	-0.1
PVC	8,014	7,812	(2.5)	PVC	8,022	7,833	-2.4
Non-PVC	15,230	16,254	6.7	Non-PVC	15,472	16,073	3.9
Cost per tonne (RMB)	7,168	7,002	(2.3)	Cost per tonne (RMB)	7,124	7,023	-1.4
Gross profit per tonne (RMB)	2,378	2,645	11.2	Gross profit per tonne (RMB)	2,474	2,570	3.9
Margins and Ratios:				Margins and Ratios:			
Gross margin	24.0%	26.2%		Gross margin	25.0%	25.6%	
Net margin	10.0%	11.6%		Net margin	10.7%	11.1%	
EBIT margin	13.2%	14.1%		EBIT margin	14.2%	13.8%	
EBITDA margin	15.7%	16.9%		EBITDA margin	16.9%	16.8%	
Effective tax rate	18%	15%		Effective tax rate	19%	16%	

Sources: Company, CGIHK Research

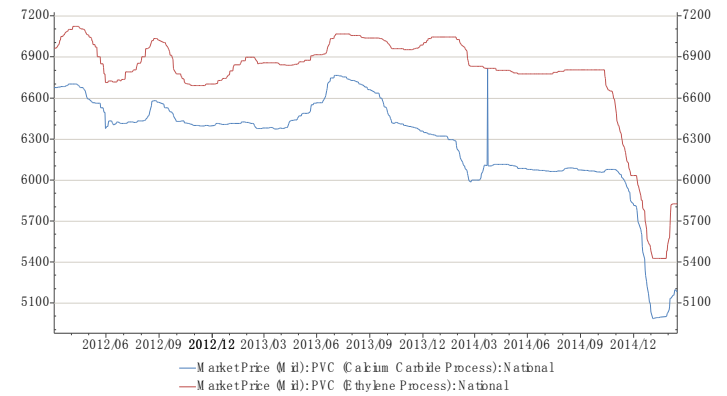
Figure 1: Brent crude prices (US\$/barrel)



Report Source: F, B, B, B

Sources: WIND Info, CGIHK Research

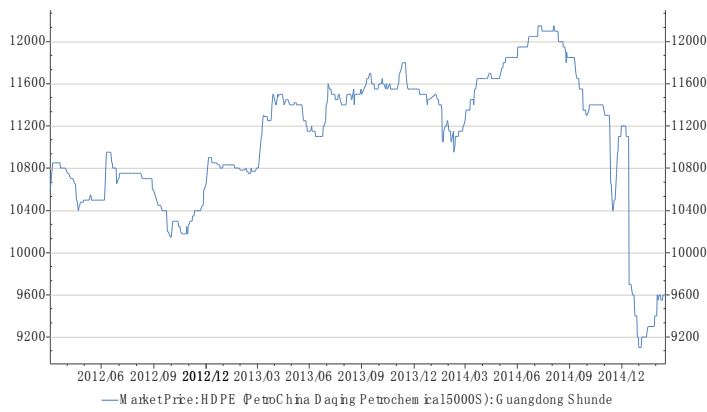
Figure 2: PVC prices (RMB/tonne)



Report Source: F, B, B, B

Sources: WIND Info, CGIHK Research

Figure 3: HDPE prices (RMB/tonne)



Report Source: F, B, B, B

Sources: WIND Info, CGIHK Research

Figure 4: PP prices (RMB/tonne)



Report Source: F, B, B, B

Sources: WIND Info, CGIHK Research

Key financials

China Lesso (02128.HK)
Income Statement
(RMB'000, except for per share amount)

Year ended 31 Dec	2012		2013		2014		2015E		2011	2012	2013	2014	2015E	2016E
	1H	2H	1H	2H	1H	2H	1H	2H						
PVC pipes	3,089,852	3,755,508	3,528,040	4,520,930	3,997,803	4,821,458	4,082,190	4,886,299	6,686,064	6,845,360	8,048,970	8,819,261	8,968,489	9,735,585
Non-PVC pipes	1,539,037	2,063,984	1,848,951	2,317,179	2,128,008	2,785,958	2,277,524	2,611,943	3,234,980	3,603,020	4,166,130	4,913,966	4,889,467	5,132,811
Others	189,794	253,188	315,232	540,215	455,240	634,305	593,800	731,950	222,251	442,983	855,447	1,089,545	1,325,750	1,586,493
Revenue	4,818,683	6,072,680	5,692,223	7,378,324	6,581,051	8,241,721	6,953,514	8,230,192	10,143,296	10,891,363	13,070,547	14,822,772	15,183,706	16,454,888
COGS	(3,570,976)	(4,671,079)	(4,200,369)	(5,604,610)	(4,938,032)	(6,084,006)	(5,181,686)	(6,178,511)	(7,691,274)	(8,242,055)	(9,804,979)	(11,022,038)	(11,360,197)	(12,377,488)
Gross profit	1,247,707	1,401,601	1,491,854	1,773,714	1,643,019	2,157,715	1,771,829	2,051,681	2,452,022	2,649,308	3,265,568	3,800,734	3,823,510	4,077,400
Operating expenses	(498,227)	(638,660)	(654,672)	(848,247)	(784,503)	(1,046,303)	(890,050)	(1,111,076)	(932,845)	(1,136,887)	(1,502,919)	(1,830,806)	(2,001,126)	(2,100,828)
Operating profit	749,480	762,941	837,182	925,467	858,516	1,111,412	881,779	940,605	1,519,177	1,512,421	1,762,649	1,969,928	1,822,384	1,976,573
Other income and gains	12,917	49,760	41,793	46,606	31,754	47,984	27,814	41,151	43,949	62,677	88,399	79,738	68,965	91,445
EBIT	762,397	812,701	878,975	972,073	890,270	1,159,396	909,593	981,756	1,563,126	1,575,098	1,851,048	2,049,666	1,891,349	2,068,018
Net finance costs	(48,311)	(63,792)	(63,160)	(64,776)	(67,885)	(36,038)	(30,673)	(16,886)	(83,317)	(112,103)	(127,936)	(103,923)	(47,558)	(41,221)
Profits from associates and JCEs	116	199	214	176	202	196	210	210	(29)	315	390	398	420	440
Non-recurring items	18,969	-	24,309	19,700	(61,365)	(37,983)	-	-	77,153	18,969	44,009	(99,348)	-	-
Income before tax	733,171	749,108	840,338	927,173	761,222	1,085,571	879,131	965,080	1,556,933	1,482,279	1,767,511	1,846,793	1,844,211	2,027,237
Income tax expense	(135,266)	(115,742)	(162,681)	(167,214)	(139,556)	(166,879)	(158,243)	(173,714)	(296,237)	(251,008)	(329,895)	(306,435)	(331,958)	(385,175)
Minority interests	2,280	4,771	5,077	6,568	5,869	7,797	4,000	-	62	7,051	11,645	13,666	4,000	-
Net income	600,185	638,137	682,734	766,527	627,535	928,489	724,887	791,366	1,260,758	1,238,322	1,449,261	1,554,024	1,516,253	1,642,062
Recurring net income	581,216	638,137	658,425	746,827	688,900	964,472	724,887	791,366	1,183,605	1,219,353	1,405,252	1,653,372	1,516,253	1,642,062
EPS (RMB)	0.198	0.210	0.222	0.249	0.202	0.298	0.233	0.254	0.419	0.408	0.471	0.500	0.488	0.528
Recurring EPS (RMB)	0.192	0.210	0.214	0.243	0.221	0.310	0.233	0.254	0.394	0.402	0.457	0.532	0.488	0.528
DPS (HK\$)	-	0.120	-	0.120	-	0.130	-	0.122	0.120	0.120	0.120	0.130	0.122	0.132
Depreciation and amortization	113,547	139,027	173,769	186,569	203,992	235,788	262,860	298,161	173,905	252,574	360,338	439,780	561,021	669,696
EBITDA	876,060	951,927	1,052,958	1,158,818	1,094,464	1,395,380	1,172,663	1,280,127	1,737,002	1,827,987	2,211,776	2,489,844	2,452,790	2,738,153
Sales volume (tonnes)	470,433	614,982	556,374	716,257	643,018	788,621	706,992	899,808	960,836	1,085,415	1,272,631	1,431,639	1,606,800	1,792,800
PVC	372,092	483,685	439,248	564,114	508,691	617,220	551,454	701,850	753,784	855,777	1,003,362	1,125,911	1,253,304	1,398,384
Non-PVC	98,341	131,297	117,126	152,143	134,327	171,401	155,538	197,958	207,052	229,638	269,269	305,728	353,496	394,416
ASP per tonne (RMB)	9,840	9,462	9,664	9,547	9,527	9,647	8,995	8,333	10,325	9,626	9,598	9,593	8,625	8,293
PVC	8,304	7,764	8,032	8,014	7,859	7,812	7,403	6,962	8,870	7,999	8,022	7,833	7,156	6,962
Non-PVC	15,650	15,720	15,786	15,230	15,842	16,254	14,643	13,194	15,624	15,690	15,472	16,073	13,832	13,014
Cost per tonne (RMB)	7,281	7,276	7,067	7,168	7,049	7,002	6,590	6,151	7,856	7,278	7,124	7,023	6,344	6,130
Gross profit per tonne (RMB)	2,559	2,187	2,597	2,378	2,478	2,645	2,405	2,183	2,469	2,348	2,474	2,570	2,281	2,164
Growth Rates:														
Revenue	6%	9%	18%	22%	16%	12%	6%	0%	32%	7%	20%	13%	2%	8%
EBIT	9%	-6%	15%	20%	1%	19%	2%	-15%	10%	1%	18%	11%	-8%	9%
EBITDA	13%	-1%	20%	22%	4%	20%	7%	-8%	13%	5%	21%	13%	-1%	12%
Core net income	8%	-1%	13%	17%	5%	29%	5%	-18%	5%	3%	15%	18%	-8%	8%
Recurring EPS	7%	-2%	12%	15%	3%	28%	5%	-18%	4%	2%	14%	16%	-8%	8%
Margins and Ratios:														
Gross margin	25.9%	23.1%	26.2%	24.0%	25.0%	26.2%	25.5%	24.9%	24.2%	24.3%	25.0%	25.6%	25.2%	24.8%
Net margin	12.0%	10.4%	11.5%	10.0%	10.4%	11.6%	10.4%	9.6%	11.7%	11.1%	10.7%	11.1%	10.0%	10.0%
EBIT margin	15.8%	13.4%	15.4%	13.2%	13.5%	14.1%	13.1%	11.9%	15.4%	14.5%	14.2%	13.8%	12.5%	12.6%
EBITDA margin	18.2%	15.7%	18.5%	15.7%	16.6%	16.9%	16.9%	15.6%	17.1%	16.8%	16.9%	16.8%	16.2%	16.6%
Effective tax rate	19%	15%	20%	18%	17%	15%	18%	18%	20%	17%	19%	16%	18%	19%

Sources: Company data, CGHK Research estimates

Key financials

China Lesso (02128.HK)

Balance Sheet

(RMB'000, except for per share amount)

	2011	2012	2013	2014	2015E	2016E
As at 31 Dec						
Inventories	1,294,018	1,766,133	2,434,049	2,210,038	2,400,000	3,600,000
Trade receivables	718,856	779,354	854,518	1,127,901	1,300,000	1,500,000
Bills receivable	32,811	243,265	218,041	216,231	230,000	230,000
Others	344,323	401,826	702,773	561,760	634,474	728,474
Bank balances and cash	2,116,641	1,922,325	2,189,242	3,198,902	3,747,864	3,259,052
Total current assets	4,506,649	5,112,903	6,398,623	7,314,832	8,312,338	9,317,526
FFE, net	2,470,759	3,288,261	4,452,109	5,263,614	5,849,083	6,222,231
Prepaid lease payments	356,065	954,279	996,690	1,087,126	1,137,126	1,187,126
Others	458,062	427,343	450,285	853,956	325,748	377,188
Total non-current assets	3,284,886	4,669,883	5,899,084	7,204,696	7,311,957	7,786,545
Total assets	7,791,535	9,782,786	12,297,707	14,519,528	15,624,295	17,104,072
Trade payables	191,314	512,054	861,416	973,387	1,050,000	1,150,000
Other payables	657,447	832,388	1,252,674	1,584,290	1,650,000	1,750,000
Bank and other borrowings	70,004	595,799	1,080,092	1,158,729	900,000	800,000
Others	114,426	98,635	103,638	113,440	99,587	115,552
Total current liabilities	1,033,191	2,038,876	3,297,820	3,809,846	3,699,587	3,815,552
Bank and other borrowings	1,674,704	1,628,783	1,607,024	2,021,105	2,021,105	2,021,105
Others	96,275	87,209	136,920	138,854	160,000	185,000
Total non-current liabilities	1,770,979	1,715,992	1,743,944	2,159,959	2,181,105	2,206,105
Total liabilities	2,804,170	3,754,868	5,041,764	5,969,805	5,880,692	6,021,657
Shareholders' equity	4,986,975	6,010,033	7,239,738	8,545,459	9,743,339	11,082,150
Minority interests	390	17,885	16,205	4,264	264	264

Statement of Cash Flow

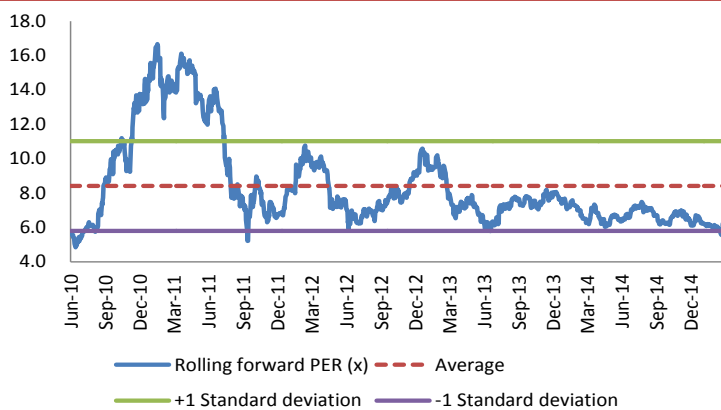
	2011	2012	2013	2014E	2015E	2016E
Year ended 31 Dec						
Profit before tax	1,556,933	1,482,279	1,767,511	1,846,793	1,844,211	2,027,237
Depreciation & Amortization	166,947	252,574	360,338	412,425	520,021	619,696
Change in working capital	(216,388)	(301,856)	(480,951)	530,061	(286,221)	(1,294,000)
Others / adjustments	(116,617)	(152,553)	(143,436)	(488,673)	290,766	(301,728)
Net operating cash flow	1,390,875	1,280,444	1,503,462	2,300,606	2,368,776	1,051,204
Capex	(990,732)	(1,067,866)	(1,161,586)	(1,260,000)	(1,100,000)	(1,000,000)
Others	(385,150)	(866,081)	(558,605)	(90,436)	(50,000)	(50,000)
Net investing cash flow	(1,375,882)	(1,933,947)	(1,720,191)	(1,350,436)	(1,150,000)	(1,050,000)
Change in debt	1,193,803	552,775	504,749	492,718	(258,729)	(100,000)
Dividends	(303,026)	(293,834)	(291,809)	(292,927)	(318,373)	(303,251)
Others	(261,745)	(133,033)	(72,555)	(140,301)	(92,712)	(86,766)
Net financing cash flow	629,032	125,908	140,385	59,490	(669,814)	(490,016)
Increase / Decrease in cash	616,349	(194,316)	266,917	1,009,660	548,962	(488,812)
Net cash/(debt)	371,933	(302,257)	(497,874)	19,068	826,759	437,947

Finance Ratios

	2011	2012	2013	2014	2015E	2016E
Valuation						
PE(x)	8.1	7.8	6.7	5.7	6.3	5.8
EPS growth (%)	4	2	14	16	8	8
Yield (%)	3.1	3.1	3.1	3.4	3.2	3.4
PEG (x)	1.87	3.75	0.49	0.35	-0.76	0.70
EV/EBITDA (x)	5.5	5.2	4.3	3.8	3.9	3.5
FB(x)	1.9	1.6	1.3	1.1	1.0	0.9
Operational						
Revenue growth (%)	32	7	20	13	2	5
Gross margin (%)	24.2	24.3	25.0	25.6	25.2	24.7
Net profit margin (%)	11.7	11.1	10.7	11.1	10.0	9.9
Days receivables	26	30	29	30	35	36
Days payables	10	16	26	30	33	32
Days inventories	58	68	78	77	74	88
Current ratio (x)	4.4	2.5	1.9	1.9	2.2	2.4
Quick ratio (x)	2.8	1.4	1.0	1.2	1.4	1.3
Asset/Equity (x)	1.6	1.6	1.7	1.7	1.6	1.5
Net debt/equity (%)	Net cash	5	7	Net cash	Net cash	Net cash
EBITDA interest coverage (x)	20.8	16.3	17.3	24.0	51.6	66.4
Core ROE (%)	26.3	22.2	21.2	20.9	16.6	15.8

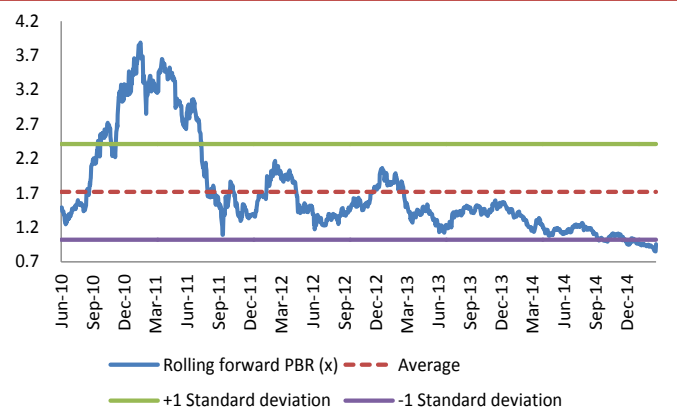
Sources: Company data, CGHK Research estimates

Figure 5: Rolling Forward PER



Sources: Bloomberg, CGHK Research

Figure 6: Rolling Forward PBR



Sources: Bloomberg, CGHK Research

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Room 3501-3507, 35/F, Cosco Tower, Grand Millennium Plaza, 183 Queen's Road Central, Sheung Wan, Hong Kong. General line: 3698-6888.