

JPM-pp1

Asia Pacific Equity Research

22 March 2015

Techtronic Industries (669 HK)

Overweight

Price: HK\$27.45

20 Mar 2015

Price Target: HK\$36.00

PT End Date: 31 Dec 2015

Cordless prowess to lift floor care – Key feedback from investor meetings

Techtronic Industries (TTI) is one of the largest producers of branded power tools and floor care products in China, with sales mainly in the US and Europe. We attended some meetings with the senior management group (including the CEO) and investors on 20 March.

The shares are up 7% over the past 3 months (vs 6% for Hang Seng Index) which is less than the 18% increase by largest customer Home Depot over this period. We believe TTI benefits from the same trends (strong demand for power tools in the US and migration of corded to cordless) that Home Depot does, but TTI should have more benefits from lower production costs as a result of falling commodity prices. Concerns over flat 2H14 floor care sales are resulting in a buying opportunity, in our view. The launch of new cordless floor care products in 2H14 are key to lifting sales and margins for this division – just give it some time.

Key highlights

Short term

The cost of key commodities – plastics, copper, other metals (together representing 30% of COGS by our estimates) – have fallen significantly (10-15%) since the end of Nov 2014 (smaller decline from Aug to Nov) and management indicated that the lower cost of materials takes 4-6 months before they are reflected in lower COGS in the accounts and that the real benefit would be more reflected in 2H15 (not in 2014).

Flat sales in 2H14 for floor care are due to TTI's decision to focus on margins rather than rapid sales growth. In addition, new cordless products (Hoover air-cordless) were only launched in 2H14 (one model) but a full line-up (over five models) has already been launched by March 2015 and we believe that this should boost 2H15 floor care sales (our FY15 floor care revenue growth is 8%).

Actively hedging away Euro risks. TTI has a policy to hedge the Euro so that sales match costs (both in euros). TTI has a natural hedge by making a large proportion of its accessories (drill bits and saw blades) in Germany. The net impact (net cost of goods sold in non-Euro currencies) are hedged with financial instruments. In particular, hedging for 2015 is done until late 4Q15 and this was done in late 2014 before the recent plunge in the Euro from Jan to March 2015. We do not expect a large FX loss related to the Euro (hasn't been seen before) in 2015.

Medium term

Cordless floor care is a new category (technology was not developed enough for a high powered vacuum at low cost before 2014) and TTI has a world leader in consumer cordless products (power tools fastest growing amongst peers) and we believe that its world's lowest cost of production (for cordless batteries used for consumers) and brand awareness for reliability (in cordless) should give TTI the lever it needs to break into the high end floor care segment (with a new differentiated product instead of just additional marketing costs).

Marketing campaign for cordless could lift SGA in 2015 – The launch of new cordless vacuums would coincide with traditional TV marketing as well as in-store promotions. We have already factored in a US\$55m increase in selling expenses (due mainly to higher sales and stable proportion of selling costs to revenues) but TTI may spend more than our expectations on what is in effect the first year of launching a very key cordless vacuum product.

Long term

TTI may do additional R&D on new products or enter new geographies in 2015. Normally the strategy of the company is to invest in the future when the core business is doing particularly well. We note that the strong demand in the US, rapid market share gains in Europe, lower cost associated with a depreciating Rmb, falling commodity costs, cost savings from closure of overseas plants in 2013 and 2014 should all combine to result in a remarkable year in 2015 in growth and margins. Management intends to build for the future in 2015 and we believe the key areas of “investing for the future” include:

- Diagnostic products using smart phones - these newly launched measurement products (Ryobi phone works)

- New hand tools (tape measures from 2 to 10 models) (new storage boxes and backpacks)
- High powered cleaning tools (for janitorial and professional services)
- New countries in focus (Spain, Turkey) as demand revives
- More spending in US (on new products) and Western Europe (to gain market share)

Please refer to our latest note, "[Techtronic Industries: Reiterate OW rating - Strong growth with margin improvement](#)" dated Mar 19, 2015 for detail.

Investment Thesis

We believe TTI should benefit from the normalization of demand for power tools and floor care products in the US, which fell from 2006 to 2012 and has just started to rebound. TTI has been gaining market share in the US during a slump in demand, and is well positioned to benefit in a recovery, in our view. TTI has 15% of its sales to Euro-denominated markets and is now benefiting from a recovery in demand in Europe, as well as the rise in the Euro in recent months.

Valuation

Our Dec-15 price target is based on our 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 have assumed a beta of 1.0. This is more conservative than the 0.7 Bloomberg beta. Accordingly, we assume a WACC of 9%. We estimate free cash flow until 2020 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in 2020 (the final year of the estimate period) subject to a minimum of 1.5% and a maximum of 4.5%, depending on the nature of the industry and the level of maturity in China.

Risks to Rating and Price Target

The key risks to our PT are a rising cost of production in China and a slower-than-expected recovery in US demand. Another risk is the implementation of new product launches and whether or not they are accepted by customers.

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<http://gps-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=503185&shareClassServerId=4&chartDesignation=1&actionType=C>

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
22-Mar-07	N	9.66	9.50
19-Apr-07	N	10.40	10.00
22-Aug-07	N	8.65	9.50
29-Jan-08	N	9.16	8.70
09-Nov-08	N	3.20	4.30
09-Jan-09	OW	2.95	4.30
04-Mar-10	OW	5.64	8.50
11-May-10	OW	7.60	11.00
15-Aug-10	OW	6.11	10.00
20-Aug-10	OW	6.48	11.00
16-Dec-10	OW	9.85	15.00
28-Mar-11	OW	9.83	14.00
22-Jul-11	OW	8.35	12.00
15-Feb-12	OW	9.92	14.00
08-Aug-12	OW	10.50	15.00
20-Aug-12	OW	11.72	16.00
14-Nov-12	OW	14.40	19.00
05-Mar-13	OW	16.68	22.50
22-Mar-13	OW	17.70	23.00
22-Aug-13	OW	18.20	24.00
29-Aug-13	OW	18.72	28.00
20-Nov-13	OW	19.12	32.00
20-Mar-14	OW	21.60	36.00

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