COMPANY UPDATE

# Ozner Water International Holding (2014.HK)

Buy

Equity Research

## Remain CL-Buy – cuts to cash flow but long-term growth on track

### What's changed

Post 2014 results, we lower non-GAAP EPS by 4.8-11% in 2015-2017E, on revenue and expense misses despite higher GPM. While our 12-month TP declines 20% to HK$4.80, we continue to view Ozner as a high-growth firm with a solid business model and 63% upside to our TP; CL-Buy.

### Implications

**1. NPM cut post 2014 result, but market gains on track.** We cut revenue by 1-3% to reflect the potential promotion on its group buying business for its strategic cooperation partners. We increase 2015E expense (non-GAAP) by 13% to Rmb210mn (+48% yoy), which we think reflects investment in brands, marketing and personnel that will support long-term sustainable growth. Our water unit forecasts remain the same, as overall demand remains on track, especially in household penetration after it launched its O2O marketing membership platform. Our new estimates imply 42% CAGR for revenue and 44% for non-GAAP net income in 2015-17E.

**2. Addressing recent independent research allegations.** We attempt to clarify concerns regarding production costs, profitability, reconciliation of tax responsibilities, sales mix, etc.

### Valuation

**Target cut 20%, but still see 63% upside**. We continue to use DCF to value Ozner, as we believe its distinctive lease and service model will lead to resilient cash generation in the future, but lower FCF progress in the near term as we are cutting operating income. Ozner now trades at a discount to regional peer Coway, 25% on 2015E P/E, and around 40% to global peers. Our TP decreases as a result of estimate changes (lower FCF) and the rollover of EV adjustment items to 2015E. WACC is unchanged at 10.35%. Our TP implies 27X 2015E P/E and 2.6X EV/GCI, which reflects a c.10% discount on previous levels.

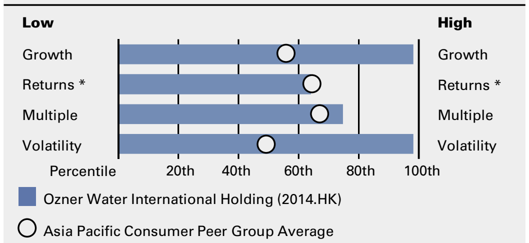
### Key risks

Risks include: worse-than-expected marketing strategy execution; lower-than-expected volume growth; intense market competition.

**INVESTMENT LIST MEMBERSHIP**
Asia Pacific Buy List
Asia Pacific Conviction Buy List

**Coverage View: Neutral**

**Investment Profile**

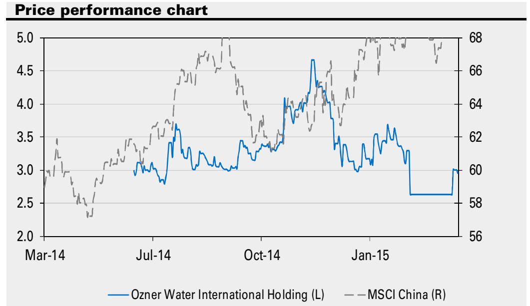



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

| Key data | Current |
|---|---|
| Price (HK$) | 2.95 |
| 12 month price target (HK$) | 4.80 |
| Market cap (HK$ mn / US$ mn) | 5,166.3 / 666.3 |
| Foreign ownership (%) | -- |

| | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| **EPS (Rmb) New** | **0.11** | **0.15** | **0.22** | **0.31** |
| EPS revision (%) | (6.5) | (10.8) | (11.1) | (4.8) |
| EPS growth (%) | -- | 38.0 | 44.8 | 44.0 |
| **EPS (dil) (Rmb) New** | **0.11** | **0.15** | **0.22** | **0.31** |
| P/E (X) | 24.8 | 15.8 | 10.9 | 7.6 |
| P/B (X) | 2.5 | 1.9 | 1.7 | 1.4 |
| EV/EBITDA (X) | 26.2 | 10.3 | 6.5 | 4.2 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| ROE (%) | 17.1 | 13.1 | 16.5 | 20.0 |
| CROCI (%) | 20.4 | 21.2 | 23.0 | 24.5 |

**Price performance chart**




| Share price performance (%) | 3 month | 6 month | 12 month |
|---|---|---|---|
| Absolute | (2.0) | (6.3) | -- |
| Rel. to MSCI China | (8.7) | (14.2) | -- |

*Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 3/30/2015 close.*

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# Ozner Water International Holding: Summary Financials

| Profit model (Rmb mn) | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| **Total revenue** | **511.7** | **754.5** | **1,087.2** | **1,511.1** |
| Cost of goods sold | (177.0) | (247.5) | (355.9) | (493.6) |
| SG&A | (192.5) | (251.5) | (289.3) | (327.9) |
| R&D | -- | -- | -- | -- |
| Other operating profit/(expense) | (0.3) | (15.0) | (15.0) | (16.0) |
| **EBITDA** | **157.4** | **379.2** | **628.3** | **965.6** |
| Depreciation & amortization | (15.5) | (138.6) | (201.3) | (291.9) |
| **EBIT** | **142.0** | **240.6** | **427.0** | **673.6** |
| Interest income | 9.0 | 8.5 | 7.3 | 9.3 |
| Interest expense | (0.7) | 0.0 | (12.0) | (24.0) |
| Income/(loss) from uncons. subs. | 0.0 | 0.0 | 0.0 | 0.0 |
| Others | 11.0 | 10.0 | 10.0 | 5.0 |
| **Pretax profits** | **161.2** | **259.1** | **432.3** | **663.9** |
| Income tax | (37.4) | (54.4) | (86.5) | (139.4) |
| Minorities | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net income pre-preferred dividends** | **123.9** | **204.7** | **345.9** | **524.5** |
| Preferred dividends | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net income (pre-exceptionals)** | **123.9** | **204.7** | **345.9** | **524.5** |
| Post-tax exceptionals | 66.3 | 57.8 | 34.3 | 22.7 |
| **Net income** | **190.2** | **262.5** | **380.1** | **547.2** |
| EPS (basic, pre-except) (Rmb) | 0.07 | 0.12 | 0.20 | 0.30 |
| EPS (basic, post-except) (Rmb) | 0.11 | 0.15 | 0.22 | 0.31 |
| EPS (diluted, post-except) (Rmb) | 0.11 | 0.15 | 0.22 | 0.31 |
| DPS (Rmb) | 0.00 | 0.00 | 0.00 | 0.00 |
| Dividend payout ratio (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| Free cash flow yield (%) | (7.9) | (7.5) | (4.3) | (0.6) |

| Balance sheet (Rmb mn) | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| Cash & equivalents | 593.7 | 254.2 | 477.6 | 452.7 |
| Accounts receivable | 43.5 | 55.5 | 51.8 | 57.3 |
| Inventory | 90.5 | 85.7 | 128.1 | 167.6 |
| Other current assets | 72.8 | 72.8 | 72.8 | 72.8 |
| **Total current assets** | **800.6** | **468.1** | **730.3** | **750.3** |
| Net PP&E | 1,414.8 | 2,108.4 | 2,795.1 | 3,509.3 |
| Net intangibles | 169.9 | 170.8 | 171.3 | 169.3 |
| Total investments | 0.0 | 0.0 | 0.0 | 0.0 |
| Other long-term assets | 64.8 | 64.8 | 64.8 | 64.8 |
| **Total assets** | **2,450.0** | **2,812.1** | **3,761.5** | **4,493.8** |
| Accounts payable | 129.2 | 188.7 | 252.9 | 307.0 |
| Short-term debt | 0.0 | 0.0 | 0.0 | 0.0 |
| Other current liabilities | 418.6 | 490.7 | 630.0 | 783.6 |
| **Total current liabilities** | **547.7** | **679.3** | **882.9** | **1,090.6** |
| Long-term debt | 0.0 | 0.0 | 400.0 | 400.0 |
| Other long-term liabilities | 6.5 | 6.5 | 6.5 | 6.5 |
| Total long-term liabilities | 6.5 | 6.5 | 406.5 | 406.5 |
| **Total liabilities** | **554.2** | **685.8** | **1,289.4** | **1,497.1** |
| **Preferred shares** | **0.0** | **0.0** | **0.0** | **0.0** |
| **Total common equity** | **1,895.8** | **2,126.3** | **2,472.2** | **2,996.7** |
| Minority interest | 0.0 | 0.0 | 0.0 | 0.0 |
| **Total liabilities & equity** | **2,450.0** | **2,812.1** | **3,761.5** | **4,493.8** |
| **BVPS (Rmb)** | **1.08** | **1.21** | **1.41** | **1.71** |

| Growth & margins (%) | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| Sales growth | 27.2 | 47.5 | 44.1 | 39.0 |
| EBITDA growth | (12.0) | 140.9 | 65.7 | 53.7 |
| EBIT growth | (13.8) | 69.5 | 77.5 | 57.8 |
| Net income growth | 23.5 | 38.0 | 44.8 | 44.0 |
| EPS growth | -- | 38.0 | 44.8 | 44.0 |
| Gross margin | 65.4 | 67.2 | 67.3 | 67.3 |
| EBITDA margin | 30.8 | 50.3 | 57.8 | 63.9 |
| EBIT margin | 27.7 | 31.9 | 39.3 | 44.6 |

| Ratios | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| CROCI (%) | 20.4 | 21.2 | 23.0 | 24.5 |
| ROE (%) | 17.1 | 13.1 | 16.5 | 20.0 |
| ROA (%) | 10.1 | 10.0 | 11.6 | 13.3 |
| ROACE (%) | 13.3 | 12.2 | 16.0 | 19.6 |
| Inventory days | 131.3 | 129.9 | 109.6 | 109.3 |
| Receivables days | 33.6 | 24.0 | 18.0 | 13.2 |
| Payable days | 192.8 | 234.4 | 226.5 | 207.0 |
| Net debt/equity (%) | (31.3) | (12.0) | (3.1) | (1.8) |
| Interest cover - EBIT (X) | NM | NM | 91.2 | 45.8 |

| Cash flow statement (Rmb mn) | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| Net income pre-preferred dividends | 123.9 | 204.7 | 345.9 | 524.5 |
| D&A add-back | 100.1 | 189.0 | 276.7 | 390.5 |
| Minorities interests add-back | 0.0 | 0.0 | 0.0 | 0.0 |
| Net (inc)/dec working capital | 87.7 | 52.4 | 25.5 | 9.2 |
| Other operating cash flow | 85.9 | 125.2 | 139.3 | 153.6 |
| **Cash flow from operations** | **397.6** | **571.3** | **787.3** | **1,077.8** |
| Capital expenditures | (768.9) | (883.5) | (963.9) | (1,102.8) |
| Acquisitions | (5.0) | 0.0 | 0.0 | 0.0 |
| Divestitures | 0.0 | 0.7 | 0.1 | 0.0 |
| Others | (243.9) | (0.7) | (0.1) | 0.0 |
| **Cash flow from investments** | **(1,017.9)** | **(883.5)** | **(963.9)** | **(1,102.8)** |
| Dividends paid (common & pref) | 0.0 | 0.0 | 0.0 | 0.0 |
| Inc/(dec) in debt | (223.0) | 0.0 | 400.0 | 0.0 |
| Common stock issuance (repurchase) | 988.8 | 0.0 | 0.0 | 0.0 |
| Other financing cash flows | 34.2 | (27.3) | 0.0 | 0.0 |
| **Cash flow from financing** | **800.1** | **(27.3)** | **400.0** | **0.0** |
| **Total cash flow** | **179.8** | **(339.5)** | **223.4** | **(24.9)** |

| Valuation | 12/14 | 12/15E | 12/16E | 12/17E |
|---|---|---|---|---|
| P/E (analyst) (X) | 24.8 | 15.8 | 10.9 | 7.6 |
| P/B (X) | 2.5 | 1.9 | 1.7 | 1.4 |
| EV/EBITDA (X) | 26.2 | 10.3 | 6.5 | 4.2 |
| EV/GCI (X) | 2.2 | 1.4 | 1.1 | 0.9 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |

Note: Last actual year may include reported and estimated data.

*Source: Company data, Goldman Sachs Research estimates.*

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# Earnings estimate changes

Following Ozner's 2014 annual result, we finetune our 2015-2017E sales estimates, and revise down non-GAAP earnings by 4.8-11% to reflect revenue and expense misses, partly offset by a gross profit margin beat. The earnings cuts were largely due to the company's investment to fuel future growth (in marketing and personnel etc.). Our new estimates imply 42% revenue CAGR and 44% CAGR for non-GAAP net income.

**Revenue adjustment is a mix of two forces:** In 2H14 new installed water purifiers increased 37% yoy (30% growth for commercial and 44% for household model). Total installed units increased to 657k (+42% yoy) as of end 2014, in line with our estimates. But revenue was 7% lower than GHe as installation skewed to the year end, which means under the same assumption of units installed, 2015 revenue would be lifted. However, we slightly cut unit prices to reflect promotion events that the company cooperates with corporate clients on. As a result, our 2015-2017E revenue estimates are cut by less than 3%.

**COGS and gross margin adjustment:** In 2014 result, consolidated GPM beat GHe by 0.6pp at 65.4% while declining 2.4pp yoy. The decline resulted mainly from a 4.6pp GPM for water purification (to 74.1%) due to higher revenue contribution from renewed units (from 41.6% in 2013 to 47.8% in 2014). And the beat was due to lower than expected per unit product cost, which we estimated to increase 25% yoy including both product upgrade and inflation effects. Overall, we expect water purification GPM to remain above 60% while declining in the long term due to a higher revenue contribution from renewed units.

Air sanitization GPM increased by 1pp yoy to 29.9% on more higher-margin medical projects, and we expect it could maintain at this level.

**Expense lifted on marketing and personnel:** Besides share option/global offering expenses, 2014 total expense was c.Rmb10mn higher than we expected, mainly on an increase in the number of staff at sales offices/call centers. As the company continues to execute its O2O (online to offline and vice versa) marketing plan initiated in late 2014, we further increase marketing and personnel expenses to reflect related investment, and we believe this will benefit the company's brand awareness and growth, especially in the household market. As a result, our total expense ratio forecast increases by 1.9-4.9pp in 2015-17E.

**Exhibit 1: Half year key operating metrics**

| (Rmb mn) | 2013H1 | 2013H2 | 2014H1 | YOY | 2014H2 | YOY | 2013 | 2014 | YOY |
|---|---|---|---|---|---|---|---|---|---|
| New water purifiers (k units) | 68 | 86 | 77 | 13.2% | 118 | 37% | 154 | 195 | 27% |
| Commercial model | 45 | 50 | 43 | -4.4% | 65 | 30% | 95 | 108 | 14% |
| Household model | 23 | 36 | 34 | 47.8% | 52 | 44% | 59 | 86 | 46% |
| Total water purifiers installed (k units) | 377 | 463 | 539 | 43.0% | 657 | 42% | 463 | 657 | 42% |
| Commercial model | 321 | 371 | 414 | 29.0% | 479 | 29% | 371 | 479 | 29% |
| Household model | 56 | 92 | 126 | 125.0% | 178 | 93% | 92 | 178 | 93% |
| **Revenue (Rmb mn)** | **179.05** | **223.29** | **232.02** | 29.6% | 279.69 | **25%** | 402.33 | **511.71** | 27% |
| Water purification services | 148.88 | 165.08 | 186.95 | 25.6% | 224.32 | 36% | 313.96 | 411.27 | 31% |
| Air sanitization services | 30.17 | 58.20 | 45.07 | 49.4% | 55.37 | -5% | 88.37 | 100.44 | 14% |
| Net profit, GAAP | 73.73 | 79.18 | 67.07 | -9.0% | 56.82 | -28% | 152.91 | 123.89 | -19% |
| **Net profit, non-GAAP** | **65.49** | 88.51 | **93.21** | 42.3% | **96.97** | **10%** | **154.00** | **190.18** | 23% |

*Source: Company data, Gao Hua Securities Research.*

## Exhibit 2: FY2014 result: Actual vs Estimate

| Ozner Financial Summary (RMB mn) Year End Dec 31st | 2011 | 2012 | 2013 | 2014 Actual | 2014 Estimate | Diff% | Comment |
|---|---|---|---|---|---|---|---|
| New water purifiers (000 units) | 107 | 202 | 154 | 195 | 194 | 0.3% | |
| Total water purifiers (000 units) | 107 | 309 | 463 | 657 | 657 | 0.1% | |
| | | | | | | | |
| Revenue | 102.3 | 290.4 | 402.3 | 511.7 | 546.8 | -6.4% | |
| Water purifier | 57.4 | 197.8 | 314.0 | 411.3 | 442.9 | -7.1% | Lower than GHe as installation skewed to the year end. |
| Air sanitization | 44.9 | 92.6 | 88.4 | 100.4 | 103.9 | -3.4% | |
| Cost of goods sold | -44.3 | -103.0 | -129.5 | -177.0 | -192.2 | -7.9% | Lower than expected unit production cost. We estimated 25% yoy increase including both product upgrade and inflation effects |
| | | | | | | | |
| Gross profit | 58.0 | 187.4 | 272.8 | 334.7 | 354.6 | -5.6% | GPM higher than expected, but still declines due to higher contribution from renew contract income |
| Total expense, GAAP | -34.4 | -65.8 | -108.2 | -192.8 | -172.1 | 12.0% | Expense higher on increase in Ads and marketing expenses, and an increase in number of staff at sales offices / calling centers |
| | | | | | | | |
| Operating income, GAAP | 23.6 | 121.5 | 164.6 | 142.0 | 182.6 | -22.2% | Due to gross profit and expense miss |
| Net interest income/(expenses) | 0.1 | 0.3 | 0.4 | 8.3 | 4.2 | 96.5% | |
| Other non-operating income/(loss) | 5.2 | 2.2 | 18.6 | 11.0 | 10.0 | 10.0% | |
| | | | | | | | |
| Pretax income | 28.9 | 124.0 | 183.6 | 161.2 | 196.8 | -18.1% | |
| Income tax | -5.9 | -22.3 | -30.7 | -37.4 | -31.5 | 18.6% | Effective tax rate higher than expected due to option expense is not tax-shield as we estimated |
| | | | | | | | |
| Net income, GAAP | 23.0 | 101.7 | 152.9 | 123.9 | 165.3 | -25.0% | Actual number included global offering expense. |
| Non-GAAP adjustments | 0.0 | 0.0 | 1.1 | 66.3 | 38.1 | 74.1% | Including option expense, global offering expense etc. |
| **Net income, non-GAAP** | **23.0** | **101.7** | **154.0** | **190.2** | **203.4** | **-6.5%** | |

*Source: Company data, Gao Hua Securities Research.*

## Exhibit 3: Earnings estimate changes

Note: non-GAAP adjustments including global offering expense, and option expense etc.
We have adjusted depreciation in EBITDA calculation to exclude duplicated RGA allocation already accounted in COGS.

| Ozner Financial Summary | | | 2015E | | | 2016E | | | 2017E | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (RMB mn) Year End Dec 31st | 2013 | 2014 | New | Old | chg% | New | Old | chg% | New | Old | chg% |
| New water purifiers (000 units) | 154 | 195 | 306 | 306 | 0.0% | 444 | 444 | 0.0% | 564 | 564 | 0.0% |
| Total water purifiers (000 units) | 463 | 657 | 963 | 963 | 0.0% | 1,407 | 1,407 | 0.0% | 1,971 | 1,971 | 0.0% |
| | | | | | | | | | | | |
| Revenue | 402.3 | 511.7 | 754.5 | 776.5 | -2.8% | 1,087.2 | 1,115.9 | -2.6% | 1,511.1 | 1,517.0 | -0.4% |
| Water purifier | 314.0 | 411.3 | 649.5 | 668.3 | -2.8% | 980.0 | 1,007.7 | -2.7% | 1,403.0 | 1,408.9 | -0.4% |
| Air sanitization | 88.4 | 100.4 | 105.1 | 108.2 | -2.9% | 107.1 | 108.2 | -1.0% | 108.2 | 108.2 | 0.0% |
| Cost of goods sold | -129.5 | -177.0 | -247.5 | -265.5 | -6.8% | -355.9 | -365.1 | -2.5% | -493.6 | -502.4 | -1.8% |
| | | | | | | | | | | | |
| Gross profit | 272.8 | 334.7 | 507.1 | 511.0 | -0.8% | 731.3 | 750.8 | -2.6% | 1,017.5 | 1,014.6 | 0.3% |
| Total expense, GAAP | -108.2 | -192.8 | -266.5 | -236.5 | 12.7% | -304.3 | -277.8 | 9.5% | -343.9 | -316.6 | 8.6% |
| | | | | | | | | | | | |
| Operating income, GAAP | 164.6 | 142.0 | 240.6 | 274.5 | -12.3% | 427.0 | 472.9 | -9.7% | 673.6 | 698.0 | -3.5% |
| Net interest income/(expenses) | 0.4 | 8.3 | 8.5 | 12.3 | -31.0% | -4.7 | 4.4 | -207.4% | -14.7 | -7.1 | 107.8% |
| Other non-operating income/(loss) | 18.6 | 11.0 | 10.0 | 10.0 | na | 10.0 | 10.0 | na | 5.0 | 5.0 | na |
| | | | | | | | | | | | |
| Pretax income | 183.6 | 161.2 | 259.1 | 296.8 | -12.7% | 432.3 | 487.3 | -11.3% | 663.9 | 695.9 | -4.6% |
| Income tax | -30.7 | -37.4 | -54.4 | -50.4 | 7.9% | -86.5 | -87.7 | -1.4% | -139.4 | -139.2 | 0.2% |
| | | | | | | | | | | | |
| Net income, GAAP | 152.9 | 123.9 | 204.7 | 246.3 | -16.9% | 345.9 | 399.6 | -13.4% | 524.5 | 556.8 | -5.8% |
| Non-GAAP adjustments | 1.1 | 66.3 | 57.8 | 48.0 | 20.5% | 34.3 | 28.1 | 22.0% | 22.7 | 18.2 | 25.0% |
| **Net income, non-GAAP** | **154.0** | **190.2** | **262.5** | **294.3** | **-10.8%** | **380.1** | **427.7** | **-11.1%** | **547.2** | **574.9** | **-4.8%** |
| | | | | | | | | | | | |
| **YoY chg %** | | | | | | | | | | | |
| Revenue | 38.5% | 27.2% | 47.5% | 42.0% | 5.5ppt | 44.1% | 43.7% | 0.4ppt | 39.0% | 36.0% | 3.0ppt |
| COGS | 25.8% | 36.6% | 39.8% | 38.1% | 1.7ppt | 43.8% | 37.5% | 6.3ppt | 38.7% | 37.6% | 1.1ppt |
| Gross profit | 45.6% | 22.7% | 51.5% | 44.1% | 7.4ppt | 44.2% | 46.9% | -2.7ppt | 39.1% | 35.1% | 4.0ppt |
| Total expense | 64.3% | 78.2% | 38.2% | 37.5% | 0.8ppt | 14.2% | 17.5% | -3.3ppt | 13.0% | 14.0% | -1.0ppt |
| Operating income | 35.5% | -13.8% | 69.5% | 50.3% | 19.2ppt | 77.5% | 72.3% | 5.1ppt | 57.8% | 47.6% | 10.2ppt |
| Pretax income | 48.0% | -12.2% | 60.7% | 50.8% | 9.9ppt | 66.9% | 64.2% | 2.6ppt | 53.6% | 42.8% | 10.8ppt |
| Net income, GAAP | 50.4% | -19.0% | 65.2% | 49.0% | 16.2ppt | 69.0% | 62.2% | 6.7ppt | 51.7% | 39.3% | 12.3ppt |
| Net income, non-GAAP | 51.4% | 23.5% | 38.0% | 44.7% | -6.7ppt | 44.8% | 45.3% | -0.5ppt | 44.0% | 34.4% | 9.5ppt |

*Source: Company data, Gao Hua Securities Research.*

# Valuation: Revised 12-month TP of HK$4.8, remains DCF-based

We continue to use the DCF method to value Ozner, for the following main reasons:

1. Under the company's distinctive lease and service model, the input cost of purifiers will be amortized over ten years, and rental for the first year will be much higher than that in subsequent years. This means in the initial stage, when the firm is growing fast, more installations will require higher capex, which often leads to both higher cash flow pressure and higher gross margins. Therefore, valuation metrics such as P/E will not be able to capture the long-term growth outlook and cash flow status, in our view.
2. Given the structure of the business, progress of FCF is slower than normal growth companies but once a strong market position is established, the business can show very resilient cash generation. We use DCF to capture this distinctive structure.

We cut 2015-2017E operating income (GAAP) by 3.5-12%. As a result, free cash flow to the firm also declines. With the rollover of EV adjustment items to 2015E and WACC maintained at 10.35%, our 12-month TP decreases to HK$4.8, implying 63% potential upside. Our TP implies 27X 2015E P/E and 2.6X EV/GCI, which already reflects a c.10% discount on previous levels. We maintain our CL-Buy.

**Exhibit 4: DCF-based target price of HK$4.8: Net debt/minority interest roll over to 2015E**

| **WACC** | **10.35%** | **DCF Valuation (CNY mn)** | |
|---|---|---|---|
| **Equity component** | | Total PV of CFs | 2,025 |
| Equity market premium | 6.5% | Terminal growth rate | **2.5%** |
| Risk free rate | 4.5% | Terminal value | 19,882 |
| Beta | **1.00** | PV of terminal value | 4,538 |
| Cost of equity | 11.0% | | |
| | | Firm value | 6,563 |
| **Debt component** | | Net debt | (254) |
| Cost of debt | **6.0%** | Minority interest | 0 |
| Tax rate | 25.0% | Implied value/ Equity value (CNY bn) | 6.8 |
| After-tax cost of debt | 4.5% | Implied value/ Equity value (HKD bn) | 8.5 |
| **Long run capital structure** | | Number of shares | 1,751 |
| Equity | 90.0% | Implied equity value per share (CNY) | 3.9 |
| Debt | **10.0%** | **Target price (HKD)** | **4.8** |

*Source: Gao Hua Securities Research.*

**Exhibit 5: Previous DCF result and WACC assumptions under TP at HK$6.0**

| **WACC** | **10.35%** | **DCF Valuation (CNY mn)** | |
|---|---|---|---|
| **Equity component** | | Total PV of CFs | 2,703 |
| Equity market premium | 6.5% | Terminal growth rate | **2.5%** |
| Risk free rate | 4.5% | Terminal value | 20,959 |
| Beta | **1.00** | PV of terminal value | 4,784 |
| Cost of equity | 11.0% | | |
| | | Firm value | 7,486 |
| **Debt component** | | Net debt | (799) |
| Cost of debt | **6.0%** | Minority interest | 0 |
| Tax rate | 25.0% | Implied value/ Equity value (CNY bn) | 8.3 |
| After-tax cost of debt | 4.5% | Implied value/ Equity value (HKD bn) | 10.4 |
| **Long run capital structure** | | Number of shares | 1,751 |
| Equity | 90.0% | Implied equity value per share (CNY) | 4.7 |
| Debt | **10.0%** | **Target price (HKD)** | **6.0** |

*Source: Gao Hua Securities Research.*

**Exhibit 6: We perform sensitivity analysis of Target Price to WACC and terminal growth assumptions**

| HK$ | **4.8** | WACC 9.4% | 9.9% | 10.4% | 10.9% | 11.4% |
|---|---|---|---|---|---|---|
| Terminal growth rate | 1.5% | 5.4 | 4.9 | 4.4 | 4.0 | 3.6 |
| | 2.0% | 5.7 | 5.1 | 4.6 | 4.1 | 3.7 |
| | 2.5% | 6.0 | 5.4 | 4.8 | 4.3 | 3.9 |
| | 3.0% | 6.4 | 5.6 | 5.0 | 4.5 | 4.1 |
| | 3.5% | 6.8 | 6.0 | 5.3 | 4.7 | 4.2 |

*Source: Gao Hua Securities Research.*

**Exhibit 7: Operating status implied by DCF valuation (TP at HK$4.8)**

| Ozner (in CNY mn) | 2011 | 2012 | 2013 | 2014 | 2015E | 2016E | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E | 2023E | 2024E | 2025E | 2026E | 2027E | 2028E | 2029E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sales | 102 | 290 | 402 | 512 | 755 | 1,087 | 1,511 | 2,005 | 2,514 | 3,055 | 3,624 | 4,122 | 4,575 | 5,079 | 5,593 | 6,106 | 6,622 | 7,126 | 7,618 |
| EBIT | 24 | 122 | 165 | 142 | 241 | 427 | 674 | 850 | 1,045 | 1,233 | 1,436 | 1,613 | 1,769 | 1,965 | 2,182 | 2,373 | 2,581 | 2,790 | 3,000 |
| Tax | (6) | (22) | (31) | (37) | (54) | (86) | (139) | (185) | (258) | (306) | (358) | (404) | (447) | (503) | (565) | (619) | (678) | (738) | (799) |
| Depreciation & amortisation | 7 | 33 | 69 | 124 | 189 | 277 | 391 | 541 | 671 | 821 | 983 | 1,133 | 1,282 | 1,430 | 1,579 | 1,725 | 1,866 | 2,004 | 2,136 |
| Change in net working capital | 42 | (6) | 70 | 127 | 103 | 70 | 49 | 31 | 24 | 9 | 7 | 2 | 6 | 7 | 5 | 2 | 2 | (2) | 1 |
| Capital expenditures & acquisition | (185) | (284) | (447) | (769) | (883) | (964) | (1,103) | (1,275) | (1,437) | (1,654) | (1,953) | (1,881) | (1,882) | (1,946) | (2,141) | (2,359) | (2,548) | (2,694) | (2,815) |
| **Free cash flow to the firm** | **(118)** | **(158)** | **(175)** | **(413)** | **(405)** | **(277)** | **(129)** | **(38)** | **44** | **103** | **114** | **463** | **727** | **953** | **1,060** | **1,122** | **1,223** | **1,360** | **1,523** |
| % chg | | -34% | -11% | -136% | 2% | 32% | 53% | 71% | 216% | 133% | 11% | 305% | 57% | 31% | 11% | 6% | 9% | 11% | 12% |
| *Discount period* | | | | | *1.0* | *2.0* | *3.0* | *4.0* | *5.0* | *6.0* | *7.0* | *8.0* | *9.0* | *10.0* | *11.0* | *12.0* | *13.0* | *14.0* | *15.0* |
| *Discount factor* | | | | | *0.91* | *0.82* | *0.74* | *0.67* | *0.61* | *0.55* | *0.50* | *0.45* | *0.41* | *0.37* | *0.34* | *0.31* | *0.28* | *0.25* | *0.23* |
| *PV of cash flows* | | | | | *(367)* | *(228)* | *(96)* | *(26)* | *27* | *57* | *57* | *211* | *300* | *356* | *359* | *344* | *340* | *342* | *348* |
| Sales Growth | | 183.9% | 38.5% | 27.2% | 47.5% | 44.1% | 39.0% | 32.7% | 25.4% | 21.5% | 18.6% | 13.8% | 11.0% | 11.0% | 10.1% | 9.2% | 8.5% | 7.6% | 6.9% |
| EBIT Margin | 23.1% | 41.9% | 40.9% | 27.7% | 31.9% | 39.3% | 44.6% | 42.4% | 41.5% | 40.4% | 39.6% | 39.1% | 38.7% | 38.7% | 39.0% | 38.9% | 39.0% | 39.2% | 39.4% |
| Net Margin | 22.4% | 35.0% | 38.0% | 24.2% | 27.1% | 31.8% | 34.7% | 32.7% | 30.8% | 30.1% | 29.6% | 29.4% | 29.3% | 29.7% | 30.3% | 30.4% | 30.7% | 31.1% | 31.5% |
| Capex to sales | 180.6% | 97.9% | 111.2% | 150.3% | 117.1% | 88.7% | 73.0% | 63.6% | 57.1% | 54.1% | 53.9% | 45.6% | 41.1% | 38.3% | 38.3% | 38.6% | 38.5% | 37.8% | 36.9% |
| Depreciation as % of Sales | 7.0% | 11.5% | 17.1% | 24.3% | 25.0% | 25.4% | 25.8% | 27.0% | 26.7% | 26.9% | 27.1% | 27.5% | 28.0% | 28.2% | 28.2% | 28.2% | 28.2% | 28.1% | 28.0% |
| Change in net WC as % of sales | 41.3% | -2.2% | 17.4% | 24.8% | 13.7% | 6.4% | 3.2% | 1.5% | 0.9% | 0.3% | 0.2% | 0.1% | 0.1% | 0.1% | 0.1% | 0.0% | 0.0% | 0.0% | 0.0% |

*Source: Company data, Gao Hua Securities Research.*

**Exhibit 8: Operating assumptions in our previous DCF with TP at HK$6.0**

| Ozner (in CNY mn) | 2011 | 2012 | 2013 | 2014E | 2015E | 2016E | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E | 2023E | 2024E | 2025E | 2026E | 2027E | 2028E | 2029E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sales | 102 | 290 | 402 | 547 | 777 | 1,116 | 1,517 | 1,991 | 2,492 | 3,022 | 3,576 | 4,059 | 4,499 | 4,988 | 5,514 | 6,078 | 6,659 | 7,242 | 7,829 |
| EBIT | 24 | 122 | 165 | 183 | 274 | 473 | 698 | 903 | 1,111 | 1,323 | 1,541 | 1,721 | 1,868 | 2,046 | 2,249 | 2,478 | 2,717 | 2,954 | 3,189 |
| Tax | (6) | (22) | (31) | (31) | (50) | (88) | (139) | (197) | (276) | (330) | (386) | (435) | (476) | (527) | (584) | (648) | (716) | (783) | (851) |
| Depreciation & amortisation | 7 | 33 | 69 | 157 | 244 | 347 | 464 | 602 | 758 | 928 | 1,110 | 1,265 | 1,427 | 1,593 | 1,765 | 1,941 | 2,117 | 2,289 | 2,459 |
| Change in net working capital | 42 | (6) | 70 | 57 | 56 | 52 | 42 | 38 | 25 | 15 | 28 | 4 | 12 | 2 | 11 | 11 | 3 | 2 | 3 |
| Capital expenditures & acquisition | (185) | (284) | (447) | (616) | (878) | (1,032) | (1,177) | (1,389) | (1,567) | (1,696) | (2,002) | (1,776) | (1,867) | (1,988) | (2,276) | (2,579) | (2,820) | (3,013) | (3,195) |
| **Free cash flow to the firm** | **(118)** | **(158)** | **(175)** | **(251)** | **(354)** | **(248)** | **(112)** | **(43)** | **52** | **240** | **291** | **780** | **963** | **1,126** | **1,165** | **1,203** | **1,302** | **1,449** | **1,605** |
| % chg | | -34% | -11% | -44% | -41% | 30% | 55% | 62% | 221% | 364% | 21% | 168% | 23% | 17% | 3% | 3% | 8% | 11% | 11% |
| *Discount period* | | | | | *1.0* | *2.0* | *3.0* | *4.0* | *5.0* | *6.0* | *7.0* | *8.0* | *9.0* | *10.0* | *11.0* | *12.0* | *13.0* | *14.0* | *15.0* |
| *Discount factor* | | | | | *0.91* | *0.82* | *0.74* | *0.67* | *0.61* | *0.55* | *0.50* | *0.45* | *0.41* | *0.37* | *0.34* | *0.31* | *0.28* | *0.25* | *0.23* |
| *PV of cash flows* | | | | | *(321)* | *(203)* | *(83)* | *(29)* | *32* | *133* | *146* | *355* | *397* | *421* | *394* | *369* | *362* | *365* | *366* |
| Sales Growth | | 183.9% | 38.5% | 35.9% | 42.0% | 43.7% | 36.0% | 31.3% | 25.1% | 21.3% | 18.3% | 13.5% | 10.8% | 10.9% | 10.5% | 10.2% | 9.6% | 8.8% | 8.1% |
| EBIT Margin | 23.1% | 41.9% | 40.9% | 33.4% | 35.3% | 42.4% | 46.0% | 45.4% | 44.6% | 43.8% | 43.1% | 42.4% | 41.5% | 41.0% | 40.8% | 40.8% | 40.8% | 40.8% | 40.7% |
| Net Margin | 22.4% | 35.0% | 38.0% | 30.2% | 31.7% | 35.8% | 36.7% | 35.1% | 33.2% | 32.7% | 32.4% | 32.1% | 31.8% | 31.7% | 31.8% | 32.0% | 32.2% | 32.4% | 32.6% |

*Source: Company data, Gao Hua Securities Research.*

**Exhibit 9: Ozner currently trades at 25%/64% discounts to Coway's P/E and P/B, and 37%/41% discounts to overall average respectively**

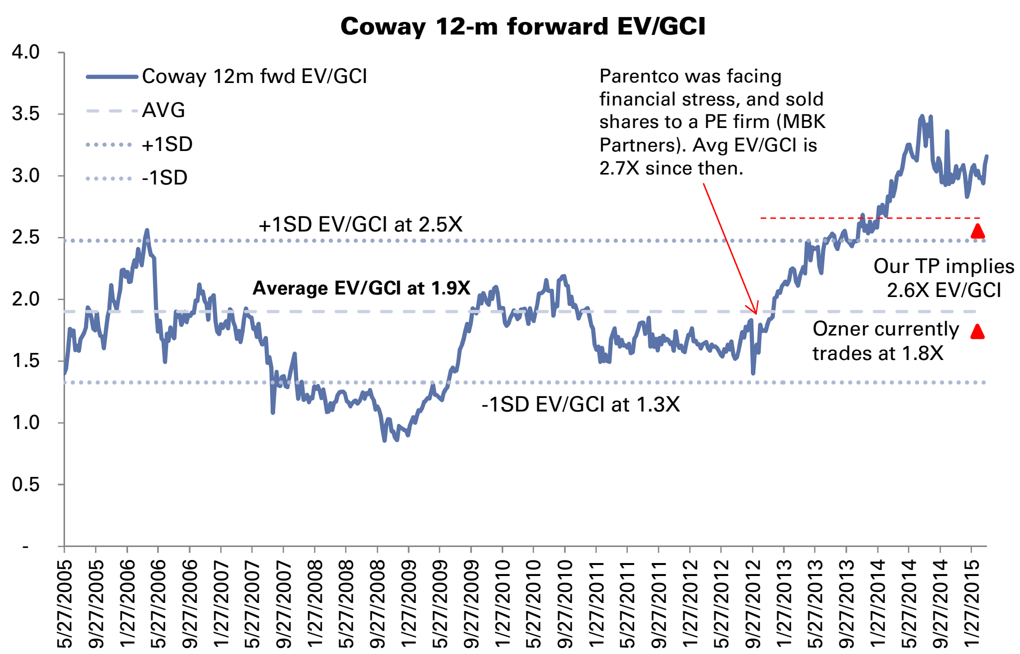
Global home appliance and water purifier business companies valuation

| Country | Ticker | Name | Mkt Cap | As of | Trading | P/E | | EV/EBITDA | | P/B | | ROE | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | US$m | 25-Mar L.C. | Ccy | CY15E (X) | CY16E (X) | CY15E (X) | CY16E (X) | CY15E (X) | CY16E (X) | CY14E (X) | CY15E (X) | CY16E (X) |
| CHINA | 002032.SZ | ZHEJIANG SUPOR-A | 2,049 | 20.08 | CNY | 15.6 | 13.1 | 11.2 | 9.4 | 2.2 | 1.9 | 18% | 19% | 19% |
| CHINA | 002242.SZ | JOYOUNG CO -A | 1,727 | 13.97 | CNY | 17.2 | 15.9 | 11.8 | 9.9 | 2.9 | 2.6 | 16% | 17% | 17% |
| CHINA | 002508.SZ | HANGZHOU ROBAM-A | 2,310 | 44.28 | CNY | 18.7 | 14.1 | 14.8 | 11.1 | 4.6 | 3.7 | 24% | 26% | 27% |
| CHINA | 002614.SZ | XIAMEN COMFORT-A | 1,228 | 21.19 | CNY | 38.5 | 27.9 | n.a. | n.a. | 2.9 | 2.7 | 6% | 8% | 10% |
| CHINA | 002035.SZ | VATTI CORP LTD-A | 844 | 14.60 | CNY | 13.9 | 11.2 | 10.8 | 8.5 | 2.9 | 2.4 | 20% | 21% | 22% |
| **Small appliances** | | **Median** | | | | **17.2** | **14.1** | **11.5** | **9.7** | **2.9** | **2.6** | **18%** | **19%** | **19%** |
| | | **Average** | | | | **20.8** | **16.4** | **12.1** | **9.7** | **3.1** | **2.6** | **17%** | **18%** | **19%** |
| BRITAIN | PNR | PENTAIR PLC | 11,514 | 63.11 | USD | 14.8 | 13.2 | 10.7 | 10.1 | 2.4 | 2.4 | 4% | 15% | 16% |
| SOUTH KOREA | 021240.KS | **COWAY CO LTD** | 6,319 | 90,200.00 | KRW | 21.5 | 19.5 | 10.6 | 9.8 | 5.6 | 4.9 | 25% | 28% | 28% |
| UNITED STATES | AOS | SMITH (A.O.)CORP | 6,073 | 63.72 | USD | 22.8 | 20.5 | 13.5 | 11.9 | 3.7 | 3.3 | 15% | 16% | 17% |
| JAPAN | 6370.T | KURITA WATER IND | 2,999 | 3,010.00 | JPY | 28.4 | 26.8 | 9.2 | 9.0 | 1.6 | 1.5 | 5% | 6% | 6% |
| SINGAPORE | HYF | HYFLUX LTD | 524 | 0.89 | SGD | n.a. | 24.7 | 32.1 | 17.7 | 0.9 | 0.8 | 7% | 0% | 5% |
| JAPAN | 6788.T | NIHON TRIM CO | 221 | 3,060.00 | JPY | 14.8 | 11.4 | 9.1 | 7.5 | 1.5 | 1.4 | 11% | 11% | 13% |
| CHINA | 300272.SZ | SHANGHAI CANAT-A | 984 | 23.95 | CNY | 72.6 | n.a. | n.a. | n.a. | 9.5 | 7.9 | n.a. | n.a. | n.a. |
| **Water treatment** | | **Median** | | | | **22.1** | **20.0** | **10.7** | **10.0** | **2.4** | **2.4** | **9%** | **13%** | **14%** |
| | | **Average** | | | | **29.2** | **19.4** | **14.2** | **11.0** | **3.6** | **3.2** | **11%** | **13%** | **14%** |
| **Overall** | | **Median** | | | | **18.7** | **15.9** | **11.0** | **9.9** | **2.9** | **2.5** | **15%** | **16%** | **17%** |
| | | **Average** | | | | **25.4** | **18.0** | **13.4** | **10.5** | **3.4** | **2.9** | **14%** | **15%** | **16%** |
| CHINA | 2014.HK | **OZNER WATER** | 594 | 2.63 | HKD | 16.1 | 11.1 | 10.5 | 6.6 | 2.0 | 1.7 | 17% | 13% | 17% |

*Source: Bloomberg estimates for Not Covered companies, Gao Hua Securities Research.*

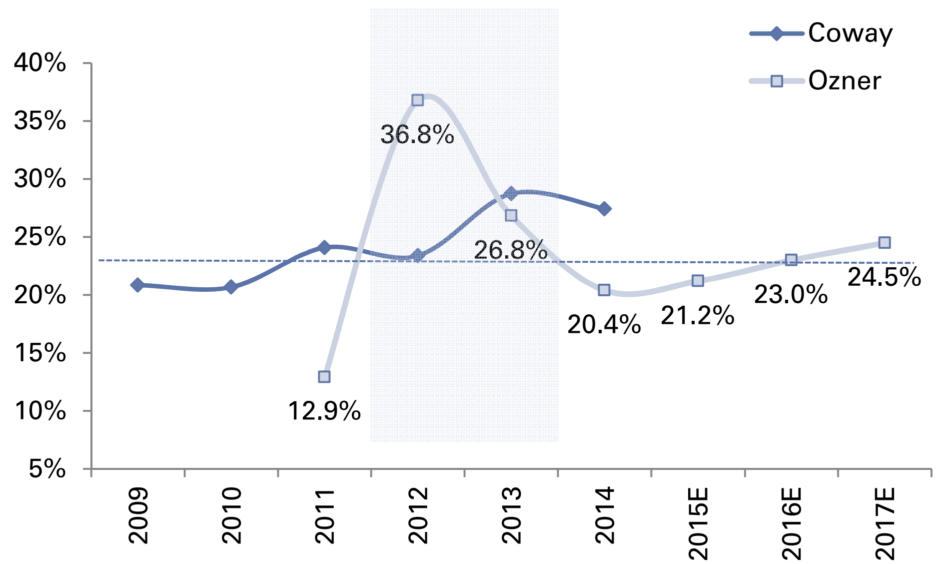
**Exhibit 10: Our TP-implied 2.6X EVGCI is at a c.20% discount to Coway's past 12-month average of 3.2X, with the discount similar to the difference in the two companies' CROCI levels (Ozner's 2015E CROCI of 21.2% is at a c.20% discount to Coway's 2014 level)...**

12-month forward EV/GCI




*Source: Datastream, Bloomberg, Gao Hua Securities Research.*

**Exhibit 11: …we expect Ozner's multiple level will improve, driven by CROCI improvement**




Note: Coway forecasts are not available as the company is not covered by GS; Ozner 2012 CROCI's surge was due to rapid increase in number of water purifiers installed from 107k in 2011 to 309k in 2012 that lifted profit by 343% yoy and CFO by 120% yoy.

*Source: Company data, Bloomberg, Gao Hua Securities Research.*

Below, we present a summary of some of the allegations against the company made in a recent independent research report and the company's responses to such allegations.

# 1. Accounting for sales, production and profit

**Issue #1**

*Production cost of Ozner's Shangyu factory (Shangyu Haorun Environmental Technology Co.) deviates from the derived water purifier costs.*

**Company's clarification:** 1) Cost of sales of the Group consists primarily of the depreciation cost of water purifiers, while the procurement cost of raw materials and components used for assembly of water purifiers are capitalized as revenue generating assets; 2) Shangyu Haorun is responsible for the assembly of water purifying machines from components and raw materials procured by other subsidiaries of the Group. Shangyu Haorun's COS mainly consists of staff costs and production overhead for assembly-related operations.

**GS additional comments:** Clear definition of subsidiaries' business functions is important. Although Shangyu Haorun is the only manufacturing company under Ozner, it only assembles products with raw materials and components procured by other subsidiaries (Shanghai Haoze and Shaanxi Haoze).

As shown in Exhibit 12, Ozner's COGS is mainly comprised of four parts (2012): Shanghai Haoze, Shaanxi Haoze, acquired Park Wealth COGS and provision of filter replacement costs. Shanghai Haoze and Shaanxi Haoze lease out water purifiers and depreciate cost of water purifiers in the same way as the group. Park Wealth COGS is estimated assuming the same unit revenue and gross margin on its 63,000 units of water purifiers when acquired by the group. Our analysis suggests that the sum of these four parts is basically in line with Ozner's group COGS.

**Exhibit 12: Our calculated water purifier COGS (calculated SUM) vs. the company's reported figures under IFRS**

| COGS (Rmb 000, except units) | 2011 | 2012 |
|---|---|---|
| Shanghai Haorun/Haoze | 4,351 | 15,532 |
| Shaanxi Haoze | - | 6,489 |
| Park Wealth | - | 2,960 |
| Provision of filter replacement costs | 5,980 | 12,750 |
| **SUM** | **10,331** | **37,731** |
| Water purifier COGS- IFRS | 10,467 | 38,601 |
| *SUM as % of IFRS COGS* | *99%* | *98%* |

| Filter replacement costs | 2011 | 2012 |
|---|---|---|
| Total units as of previous year end | 92,000 | 170,000 |
| Per unit filter cost (Rmb) | 65 | 75 |
| Replacement cost estimate | 5,980 | 12,750 |

*Source: SAIC fillings, Company data, Gao Hua Securities estimates*

**Exhibit 13: HK Fresh Water and its PRC subsidiaries' business from Prospectus**
From company prospectus p108

| Name of Subsidiary | Date of Establishment/ acquisition | Ownership by our Group | Principal activities |
|---|---|---|---|
| HK Fresh Water . . . . . . . . . | August 31, 2010 | 100% | Investment holding |
| Shanghai Haoze Environmental Technology | November 17, 2010 | 100% | Sale of water purification/air sanitization products |
| Shanghai Haoze Water Purification Technology . . | December 17, 2010 | 100% | Water purifying services |
| Shanghai Haorun Environmental Works. . . . | December 18, 2010 | 100% | Air sanitization construction service |
| Shangyu Haorun Environmental Technology | September 9, 2010 | 100% | Manufacturing of water purification/air sanitization products |
| Shaanxi Haoze Environmental Technology | March 7, 2012 | 100% | Water purifying services |
| Shaanxi Haoze Air Purification Technology . . | August 22, 2012 | 100% | Air sanitization products |

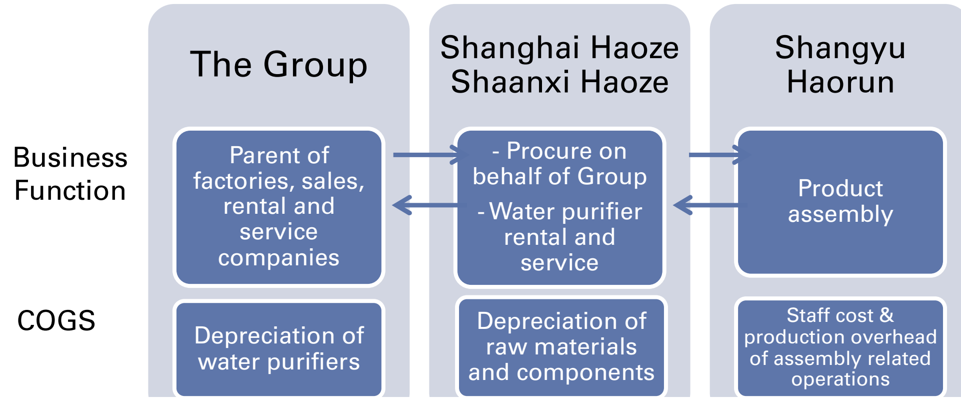
*Source: Company data.*

**Exhibit 14: Park Wealth and its subsidiaries' business from Prospectus**
From company prospectus p109

| Name of Subsidiary | Date of Establishment | Ownership by our Group | Principal activities |
|---|---|---|---|
| Park Wealth. . . . . . . . . . . . | May 23, 2007 | 100% | Investment holding |
| Shanghai Comfort . . . . . . . | September 23, 2005 | 100% | Development and manufacturing of water purification/air sanitization products |
| Shanghai Comfort Environmental Works. . . . | December 7, 2007 | 100% | Air sanitization construction service |
| Shanghai Comfort Water Purification . . . . . . . . . . . | December 7, 2007 | 100% | Development and manufacturing of water purification/air sanitization products |
| Shanghai Hongjia Air Purification . . . . . . . . . . . | December 20, 2007 | 100% | Sale of air sanitization products |

*Source: Company data.*

**Exhibit 15: Considering subsidiaries' business function and cooperation, the Group's raw material and component costs should reference Shanghai Haoze and Shaanxi Haoze, rather than Shangyu Haorun**




*Source: Gao Hua Securities Research.*

**Issue #2**

*Discrepancies in revenue generating assets (RGA) and PP&E between SAIC filings of subsidiaries and Ozner's Prospectus disclosure.*

**Company's clarification:** Miscalculation. RGA and PP&E in SAIC filings did not include investments made to the construction of the new facilities in Shaanxi Province, so such investment should not be subtracted from RGA and PP&E.

**Exhibit 16: Total Revenue Generating Assets and PP&E in SAIC filings and IFRS are not materially different (as of 2012)**

| Rmb 000 | SAIC fillings | IFRS | Difference |
|---|---|---|---|
| Shanghai Haoze | 181,058 | 193,659 | 7.0% |
| Shaanxi Haoze | 176,868 | 180,960 | 2.3% |
| **Subtotal** | **357,926** | **374,619** | **4.5%** |
| | | | |
| Shangyu Haorun | | 29,941 | |
| Park Wealth | | 57,683 | |
| Other Subsidiaries | | 4,699 | |
| Construction in progress | | 4,306 | |
| **Total RGA and PP&E** | | **471,248** | |

*Source: Company data.*

**GS additional comments:** As discussed in issue #1, Shaanxi Haoze procures raw materials, rents and provides services for water purifiers, but is not involved in manufacturing. The Shangyu factory is managed by the Group, not Shaanxi Haoze. In Exhibit 16, the company shows total RGA in SAIC filings with less than a 5% difference from IFRS numbers, vs. a 34% alleged discrepancy.

### Issue #3

*Shanghai Ozner and Shaanxi Ozner's combined sales appear lower than Ozner's consolidated sales under IFRS.*

**Company's clarification:** The discrepancy between SAIC filing and IFRS sales was due to a difference in timing of revenue recognition for accounting and tax reporting purposes.

- The Group recognizes revenue from water purification services on a monthly basis over the one year lease term.
- Revenue reported to the local tax bureau in SAIC filings was recognized when relevant invoices were issued to principal distributors – typically at the end of lease terms.

As a result, a portion of revenue recognized under IFRS was in effect deferred to the following fiscal year in SAIC filings.

**GS additional comments:** The timing difference results in both a revenue and profit/tax discrepancy. According to the Prospectus, the company is advised by a PRC legal adviser that it did not have any non-compliance with regard to tax obligations during the Track Record Period.

From Exhibit 17, we can see that the rental income difference between IFRS and SAIC as a % of total rental income under IFRS decreased from 53.1% in 2011 to 18.7% in 2014.

**Exhibit 17: Reconciliation of IFRS and SAIC revenue (Rmb 000)**

| RMB'000 | 2011 | 2012 | 2013 | 2014 | Rental income under statutory financial statements (SAIC) - A | Difference between rental income under IFRS and Statutory financial statements - B | Diff%(=B/(A+B)) |
|---|---|---|---|---|---|---|---|
| Filed with SAIC in the year of | | | | | | | |
| 2011 | 24,972 | - | - | - | 24,972 | 28,314 | 53.1% |
| 2012 | 28,341 | 62,422 | - | - | 90,763 | 104,733 | 53.6% |
| 2013 | - | 133,047 | 19,326 | - | 152,373 | 153,121 | 50.1% |
| 2014 | - | - | 286,168 | 31,517 | 317,685 | 73,116 | 18.7% |
| 2015 | | | | 359,284 | | | |
| Rental income recognized under IFRS | 53,286 | 195,469 | 305,494 | 390,801 | | | |

*Source: Company data.*

**Exhibit 18: Illustration of timing difference in cash flow, revenue recognition under IFRS and revenue filed with SAIC: assuming Rmb1200 annual rental income**

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sept | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Contract starts | | | | | | |
| **Cash inflow** | | | | | | 1200 | | | | | | |
| **Revenue recognition (IFRS)** | | | | | | | | | | | | |
| *This year* | | | | | | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| *Next Year* | 100 | 100 | 100 | 100 | 100 | | | | | | | |
| **Revenue filed with SAIC** | | | | | | 1200 | | | | | | |
| | | | | | | Contract ends | | | | | | |

*Source: Gao Hua Securities Research.*

**Issue #4**

*Shangyu factory's trade payables are significantly lower than Ozner's consolidated financials, which could suggest sales are not being properly accounted for.*

**Company's clarification:** Shangyu Haorun is not responsible for the procurement of raw materials and components; as such the Shangyu Haorun trade payable balance represented a small portion of the trade payable balance of the Group. The company has provided a reconciliation of trade payable balance of Shangyu Haorun, Shanghai Haoze Environmental and Shaanxi Haoze between their respective SAIC filings and the Prospectus.

**GS additional comments:** As discussed in #1, it is important to understand the business function of Ozner's Shangyu factory. Shangyu factory's trade payables do not represent the Group's payables to raw material and component suppliers.

## 2. Results generated by similar businesses in CGL vs. Ozner

**Issue #5**

*Ozner acquired Shanghai Comfort (water purifier leasing business) from Chaoyue Group Limited (CGL) in September 2012. Shanghai Comfort had until that point made meaningful losses from operations. This business should not be able to generate much better results under Ozner's operation.*

**Company's clarification:** It is important to consider key differences between CGL and Ozner water purification businesses including in terms of business focus, investment scale, geographic reach, distributor network, and board and management expertise. The company also sets forth factors which they believe were some of the key reasons behind the different results achieved by CGL and Ozner in respect of a similar business.

**GS additional comments:** The leasing business model requires large cash flow investment ahead of income (under this business model, the cash payback period is c.2 years). Together with investment in building factory capacity and local service teams, capital input is an important factor determining the expansion speed and revenue growth of a water purifier lease and rental business.

In terms of profitability, CGL's water purification business appears very volatile, even more so than Ozner's in 2012. In CGL's 2012 annual report (fiscal year end Mar 2012), its water purification business net margin was 42.5% vs. Ozner's 22% in 2011 and 35% in 2012.

**Issue #6**

*CGL sold Shanghai Comfort (water purifier leasing business) to Ozner for HK$78.5mn, which is equal to only 1.5% of Ozner's market cap as of the report date.*

The company did not address this issue directly.

**GS comments:** We think the acquisition price of Shanghai Comfort in 2012 is not comparable to Ozner's current market value, considering notably the increase in revenue generating assets (water purifiers), upgrade of products (reflected in COGS) and valuation multiple.

Shanghai Comfort was leasing 63,000 water purifiers as of the acquisition date. So the HK$78.5mn purchase price implied c.Rmb1,000 value per purifier with c.1X P/B. We forecast that Ozner will have accumulated over 960,000 installed water purifiers by 2015.

**Exhibit 19: Increase in water purifiers, upgrade of products and market multiple drives a significantly higher valuation of Ozner vs. M&A value for Shanghai Comfort in 2012**

| | Scenario 1 | Scenario 2 | Scenario 3 |
|---|---|---|---|
| | 2014 | 2015E | 2015E |
| Units of water purifiers installed | 657,000 | 963,000 | 963,000 |
| Per unit book value (Rmb) | 1,600 | 1,600 | 1,600 |
| P/B reference | Coway 2014 average | China appliance listco average | Coway current price implied |
| P/B Target | 5.3 | 3.0 | 5.6 |
| Per unit market value (Rmb) | 8,480 | 4,800 | 8,960 |
| Market value of water purifier business (HK$ mn) | 6,964.2 | 5,778.0 | 10,785.6 |

*Source: Company data, Gao Hua Securities Research.*

**Issue #7**

*CGL signed an agreement with Shanghai Haoyang, subcontracted responsibility to installed purifying machines and right to market and lease new ones, at an annual fee of HK$12.5mn. This appears to be an indictment of Ozner's current valuation.*

The company did not address this issue directly.

**GS comments:** We do not think the value and business of Shanghai Comfort on its own is determinative of Ozner's current value and business situation.

# 3. Undisclosed related party transactions

**Issue #8**

*Shanghai Haoyang Environmental Technology (Shanghai Haoyang), which sub-contracted the rights to run water purifier business from CGL to Ozner, was not an independent third party as disclosed in Ozner's prospectus. Shanghai Haoyang's shareholder (60%) Mr. Jianping Xiao is Ozner's shareholder (0.05% immediately following IPO) and manager of a subsidiary (Shanghai Haorun Environmental Works).*

**Company's clarification:** Subcontracting between Shanghai Haoyang and Shanghai Comfort was effective from Jan 2011 and terminated in Sept 2012. Before the subcontracting, Haoyang's shareholders were independent third parties. Following the subcontracting arrangement the Group appointed Mr. Xiao Jianping a director of one of the subsidiaries.

The company recognizes that the statement in the prospectus referring to the independent third party status of Shanghai Haoyang was not entirely accurate. However, as there is no financial impact from this inaccuracy to the Group's result, the company believes this inaccuracy is immaterial.

Moreover, as Haoyang sub-contract was terminated before the date of the prospectus, it is not required to be disclosed as a connected transaction.

Mr. Xiao Jianping is not currently a shareholder of Ozner, but was granted pre-IPO options which are not yet vested.

**GS additional comments**: The inaccuracy in the statement of the subcontract does not appear to have any financial impact and was terminated before the IPO. However, we think that the company should enhance internal controls over the identification and reporting of connected transactions.

# 4. Tax records and implications for the company's profitability

**Issue #9**
*The VAT difference between Shangyu factory and the Group indicates Ozner's net income was substantially less than reported.*

**Company's clarification:** First, Ozner notes that Shangyu Haorun was not the sole entity responsible for VAT associated with raw materials and components procured by other group subsidiaries as discussed above. It is important to consider the impact of business tax (''BT'') and VAT that were applicable to other group subsidiaries which were related to the water purification service business. Second, it is essential to consider the effect of the variability caused by the mix of different tax schemes applicable at different time periods and other offsetting factors that affected the Group's ultimate tax obligations as related to the water purification service business.

**GS additional comments**: Again, similar with argument #1 and #4¸ it is important to understand Shangyu factory's business function. Shangyu factory's VAT could not represent the company's VAT, so the figure for the former is far smaller than for the latter. We think the company's detailed calculation and explanation is clear on this point.

**Issue #10**
*If profits are not overstated then the difference between income tax paid and tax payables would suggest Ozner is accumulating tax liabilities and not paying income taxes.*

**Company's clarification:** Income tax payable was primarily attributable to the timing difference in revenue recognition for accounting and tax reporting purposes. Ozner recognizes revenue of water purification services on a monthly basis over the one-year lease term for accounting purposes, whereas revenue reported to the local tax bureau is revenue for which invoices were already issued to principal distributors. Ozner typically issues invoices to principal distributors at the end of lease terms, which it believes is consistent with market practice for the leasing business.

Ozner claims that it is not required to pay income taxes because it has not yet invoiced its distributors, even though it has already received cash payments for leasing the machine and it has already recognized revenue for the transaction.

**GS additional comments**: Ozner's clarification is consistent with the related statement in its prospectus. From Exhibit 19, we can see that the difference between the profit before tax under IFRS and SAIC became smaller, which is in line with the trend as we discussed in #3 and Exhibit 17.

The auditor, Ernst & Young, confirms that it has not withdrawn its audit opinions in the accountants' report included in the Prospectus as they relate to the Group's combined financial statements for the years ended December 31, 2011, 2012 and 2013.

**Exhibit 20: Reconciliation of profit before tax under IFRS and SAIC filings**

| RMB'000 | 2011 | 2012 | 2013 |
|---|---|---|---|
| **combined profit before tax-under IFRS as per prospectus - A** | **28,884** | **124,033** | **183,579** |
| **yoy%** | | **329.4%** | **48.0%** |
| **Reconciliation Item** | | | |
| Gross profit adjustment | (37,656) | (125,778) | (148,079) |
| Under/(Over)-accrual of other taxes and surcharges | 4,180 | 4,491 | (2,334) |
| Under-accrual of payroll expenses | 2,303 | 2,835 | 1,113 |
| Under-accrual of other expenses | 2,593 | 3,822 | 6,904 |
| Under-accrual of repair expenses | 883 | 3,464 | 11,606 |
| Over-accrual of loan interest expenses | - | - | (2,436) |
| Provision for IPO expenses | - | - | 11,218 |
| Adjustment for capitalization of expenditures in respect of revenue generating assets | - | - | (12,004) |
| | | | |
| **Profit before tax per management accounts - B** | **1,187** | **12,867** | **49,567** |
| **yoy%** | | **984.0%** | **285.2%** |
| **Income tax expense per statutory financial statements** | **-** | **2,873** | **7,523** |
| Income tax rate under SAIC | - | 22.3% | 15.2% |
| B/A | 4.1% | 10.4% | 27.0% |
| | | | |
| **As per the Prospectus** | | | |
| Profit before tax under IFRS | 28,884 | 124,033 | 183,579 |
| Current tax under IFRS | 10,132 | 23,266 | 32,888 |
| Deferred tax under IFRS | (4,200) | (924) | (2,221) |
| Income tax expense under IFRS | 5,932 | 22,342 | 30,667 |
| Income tax rate under IFRS | 20.5% | 18.0% | 16.7% |
| | | | |
| **Income tax payable as of Jan 1 of the fiscal year** | **19** | **10,151** | **34,209** |
| Provision(current tax as per the Prospectus) | 10,132 | 23,266 | 32,888 |
| Acquisition of Park Wealth | - | 816 | - |
| **Tax payments( as per the Prospectus)** | **-** | **(24)** | **(2,930)** |
| **Income tax payable as of December 31** | **10,151** | **34,209** | **64,167** |

*Source: Company data.*

# 5. Presentation of market share

**Issue #11**

*Six consumer and industry surveys in 2013 and 2014 do not list Ozner among the top 10 brands, contrary to the top ranking in prospectus.*

**Company's clarification:** The rankings listed are not appropriate for assessing the Group's market position on account of their unquantified ranking criteria, uncertified research publishers, unclear data sources and ambiguous ranking methods, contrary to the rankings cited in the prospectus.

**GS additional comments:** Ozner's business began with commercial clients and it has been in the household market only since 2011. As such, its brand name was not as well known as Midea, Qinyuan and other leaders in the household water purifier market. According to the latest China water purifier brand ranking by Sina.com in December 2014, Ozner ranked as no. 2 among the Top 10 brands and no. 4 in product innovation. (Source: http://jiaju.sina.com.cn/news/20141204/393676.shtml).

**Issue #12**

*Ozner's water purifiers do not rank in the top 10 on Tmall or top 15 on Taobao. In the last 30 days, sales of competitors such as Midea, Angel and Qinyuan were in the hundreds of units, but Ozner only sold c.100.*

**Company's clarification:** Ozner generated substantially all its revenue of water purification business from leasing fees, and generated less than 2% of revenue in 2011-13 from sales for the purpose of brand promotion. The company does not expect to increase sales through retail or online channel in the near future.

**GS additional comments:** Ozner operate its water purifiers under a lease model, which is different from the sales model of its major competitors. Ozner uses third-party online stores (such as Tmall/Taobao/JD etc.) for marketing and brand image display, but do not rely on them for sales. Instead, Ozner launched its own O2O marketing membership platform last October, and has reached more than 1mn Wechat/ mobile app users. Online strategy is very important to Ozner, but it operates in a differentiated way from other product sales brands.

# 6. Depreciation method

**Issue #13**

*Ozner assumes a 10-year useful life for water purifiers, but CGL reassessed to cut to 5 years in 2010.*

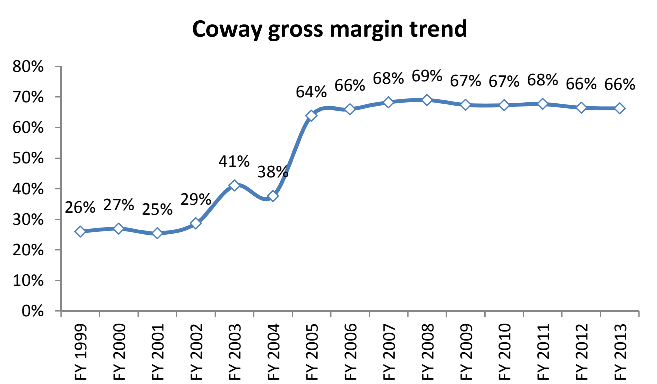
**Company's clarification:** An independent certified professional appraiser estimated Ozner's water purifiers to have a 10-year useful life.

For the c.55,000 water purifiers installed as of 2008 end, c.51,000, or 92% of them remained installed at end users as of Jan 31, 2015, after more than six years of use and they remain in a satisfactory condition.

**GS additional comments:** This is not a new concern from investors as we discussed in our report "*New O2O marketing strategy, upgrade volume estimates*" published on Jan 14, 2015.

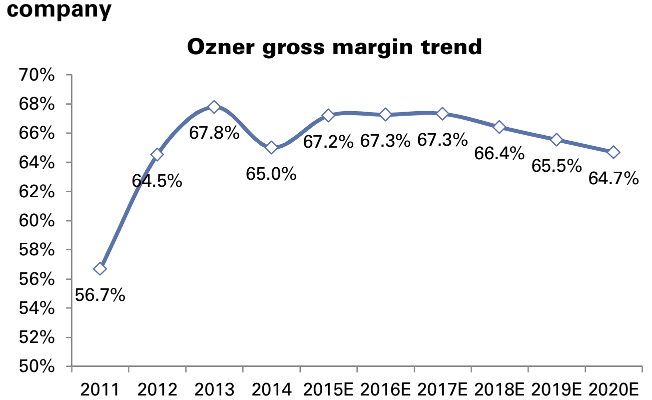
We think Ozner's water purifiers could last for ten years as long as the renewal rate of rental contracts is sufficiently high, because the core consumable component – filters – are replaced every year. The depreciation period could affect short-term earnings but not long-term cash flows, and as such, we use DCF to value the company.

**Exhibit 21: Coway's gross margin has shown a different profile from Ozner's given a different depreciation method**




*Source: Company data.*

**Exhibit 22: We forecast a gross margin downtrend for Ozner's water purifier business, and use DCF to value the company**




*Source: Company data, Gao Hua Securities Research.*

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I, Weibo Hu, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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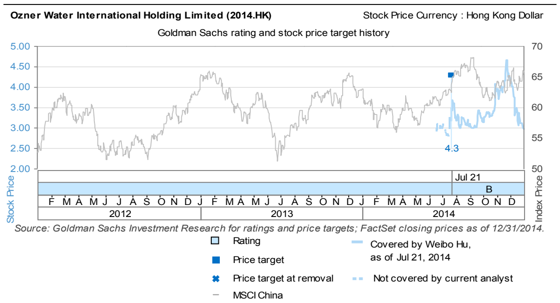


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