October 3, 2014

Asia Pacific | Machinery

Kone Corporation (KNEBV FH)

Initiation

Going Down

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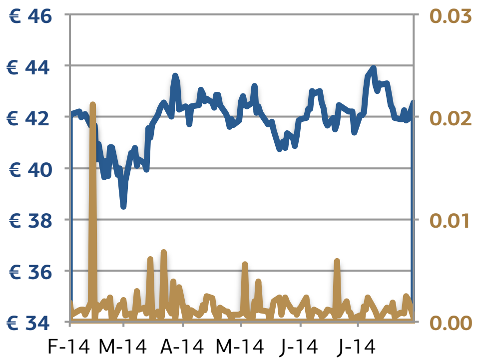
Kone (KNEBV FH) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg October 2, 2014

Kone Corporation (KNEBV FH)

Price	EUR 31.85
Rating	**SELL**
Price target	**EUR 25.70**
Difference	**19%**
Market Cap	14.2 bln
Simple Moving Avg.	23 mln
P/E	25.7x
Float	100%

Source: Bloomberg October 2, 2014

– Kone growth comes from China

30% of sales and 50% of new equipment orders come from China. Without China, Kone would have had no growth and flat margins in recent years. We expect China sales to decline 20% over the next 12 months and margins to fall from 14% to 12%.

– Delayed orders a harbinger of sales decline

We are seeing delayed orders in the industry of up to 40% for some manufacters and on average of around 25%. Kone has better delay rates than most—an average of 10% with some regions up to 30%--but this is still a signal of a turn in the market.

– Sales flat to down 4Q, down 2015

Our checks are indicating that Kone sales will be flat in core markets in 4Q and down in the peripheral markets. Almost everyone we spoke with expected sales to fall in 2015.

– Property construction declining

New starts had negative growth for five consecutive months this year and remain down YTD. Our steel and cement checks indicate property construction has already fallen 20-30% in peripheral markets and is flat to down in core markets such as East China. We believe poor new starts will see construction in core markets also fall by around 20% in 2015. Kone China sales have lagged this decline and grown at around 10% this year, because the falling starts take about a year to hit. Kone sales will fall in 1H 2015, as negatve new starts in 1H 2014 impact sales. Our base case is that Kone sales fall 20% in 2015.

– Dividend payout ratio to decline

The Kone dividend payout ratio has been greater than 100% of net profit for the past two years, as the company handed back cash from the good years. Falling profits and dividend payout ratios will reduce the attractiveness of holding this stock.

– Recommend: SELL, PT EUR 25.70, downside 19%

Our base case assumes that sales in China fall 20% in 2015 and grow in the rest of the business at 3% and that net margin will fall by 2%. We have used a weighted cost of capital of 8.9%.

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KONE: Exposed

China drove all the growth in the past 5 years for Kone

The Chinese property construction boom has peaked, and elevator sales will stall in 4Q 2014 and fall in 2015. China drives growth in global elevator sales, accounting for 55% of all new equipment sales. Some 30% of Kone's sales and 50% of new equipment sales are in China. As elevator sales fall in China, so will Kone's sales and margins.

Company overview

Kone, a Finnish company, is one of the top four global elevator manufacturers. It is second by market share globally and No. 1 in China. A decade ago, two-thirds of the company's sales came from Europe, 22% from the Americas, and 12% from Asia Pacific, while now, Asia Pacific represents around 40% of sales, while Europe has fallen below 50%, and the Americas has shrunk to 16%.

Kone and Schindler are the only two pure-play companies which manufacture only elevators and escalators; all the other major elevator companies are divisions of major corporations.

Kone is a great company that has managed expansion in China better than any competitor. Since 2010, almost all of Kone's growth has come from China. This has been the driver of Kone's share price doubling in that time. This success has left the company highly exposed to the property downturn that is under way.

Table 1. Kone Performance Relies on China

Indicator	2010	2014	Growth
Share Price	16	32	100%
P/E	17%	22%	29%
EBIT Margin	12%	14%	17%
China % Sales	13%	30%	140%
China % NE Sales	23%	50%	114%
China % Growth	100%	74%	

Source: Company Reports, J Cap

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Table 2. Kone: Comparable Analysis

Ticker	Name	Mkt Cap Bln	P/E	Rev G 1YR	EPS G 1YR	Price G 1YR
KNEBV FH	KONE	16.7	22.3	9.9%	15.9%	-2.3%
SCHP VX	SCHINDLER	12.0	24.5	6.7%	-38.0%	-3.9%
UTX US	UNITED TECH (OTIS)	96.6	17.3	8.5%	16.6%	-1.7%
TKA GR	THYSSENKRUPP	11.7	13.1	-7.2%	59.0%	15.4%

Source: Bloomberg, 1 October 2014

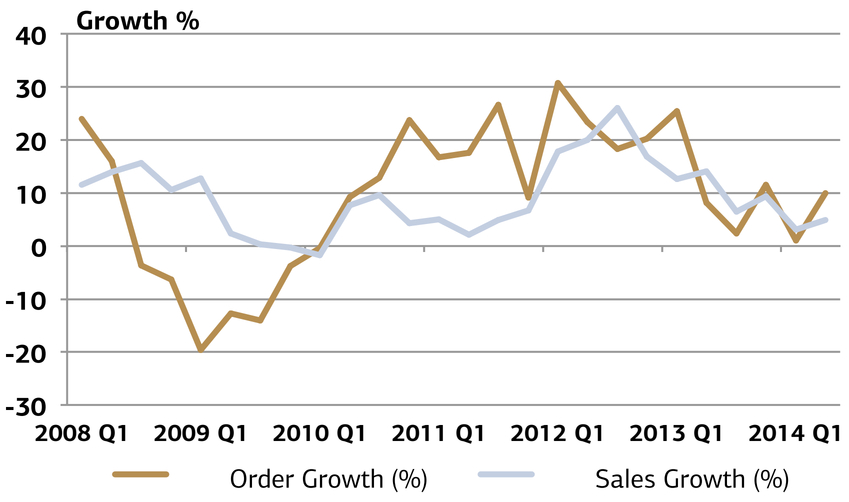
When the Chinese construction market turned down in 2009, Otis, the market leader, saw sales drop 8% and Mitsubishi, the No. 2 at that time, had sales drop by 80%. At that time, China sales were 15% of Kone's sales, while now China is 30%.

Kone should see a 6% sales decline in 2015.

Kone has experienced annual sales growth of 30% in China since 2009, well above the market rate of 20%. This growth was maintained by the acquisition of its key joint venture, GiantKone, which services the lower-end market, including elevators for social housing. Social housing growth has been strong since 2010. This segment is lower-margin and more competitive. Kone derives 30% of its sales from this segment, compared with Otis, the now No. 2 player in China which gets 20% from social housing.

Property construction is again contracting, and we expect it to fall by 20% in 2015. Kone, with its much greater exposure to China, will see sales drop 6% in 2015 and 2016 as a result of a property slowdown in China.

Chart 1. Kone global orders and sales



Source: Company, J Capital

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For Kone, 30% of sales are to China, and 50% of all new business

Table 3. China elevator market share and its importance to manufacturers 2013

Company	Global Mkt Share	China Market Share	Elev as % of group Rev	China as % of Elev Rev	China as % of New Elev Sales
UNITED TECHNOLOGIES (OTIS)	25%	16%	20%	27%	60%
Mitsubishi	6%	10%	5%	50%	40%
Hitachi	5%	11%	3%	50%	50%
SCHINDLER	15%	14%	100%	21%	55%
KONE OYJ-B	19%	19%	100%	30%	40%
THYSSENKRUPP	14%	10%	15%	25%	30%
Other	18%	20%			

Source: Company Reports, J Capital

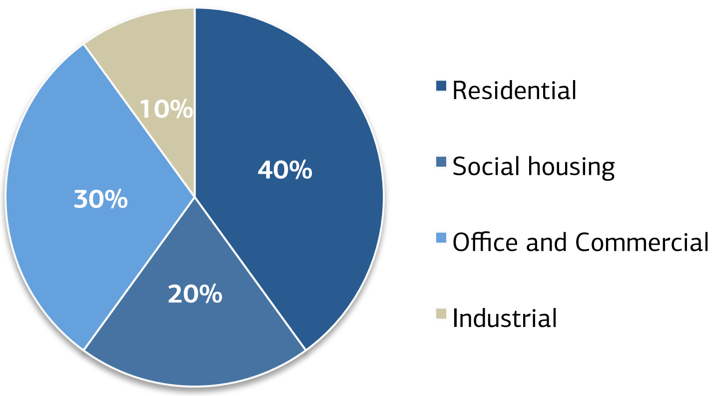
China elevator market

China now accounts for 55-60% of all new elevator sales globally. Total sales grew from 529,000 units in 2012 to 620,000 units in 2013, according to Chinese statistics. The Chinese market for new elevator equipment has been growing at an annual rate of over 20% for the last 10 years and was growing greater than 20% in 2013.

Residential dominates

Residential property dominates sales, with 60% of elevator sales. Social housing is the key growth area now.

Chart 2. Estimate of Market Composition



Source: Otis, J Capital

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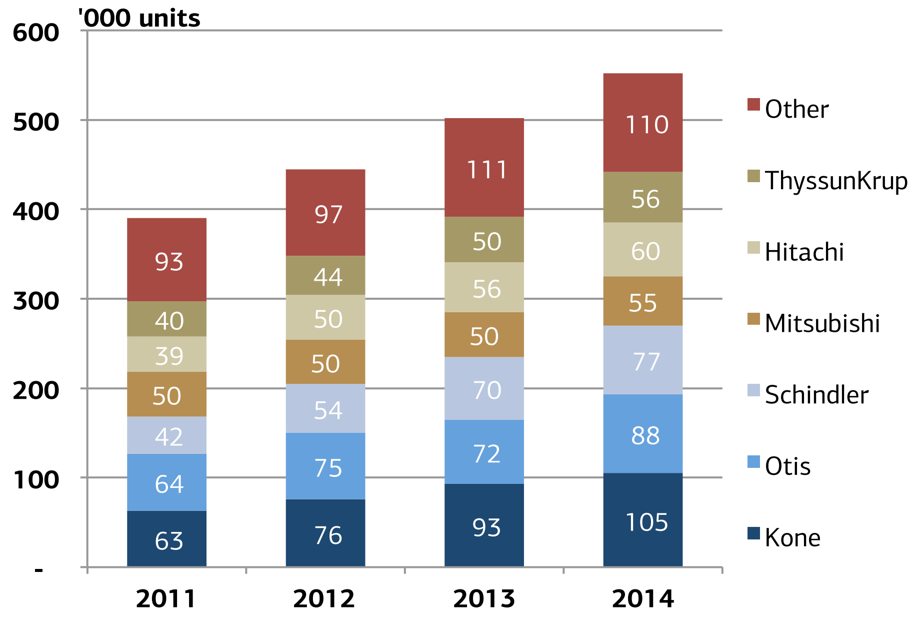
Europeans brands grow, domestic brands decline

China growth maintained by key acquisitions

Otis was the market leader in China until recently when Kone overtook it in 2012. Mitsubishi and Hitachi, have each held around 10% market share. In recent years the European multinationals have invested heavily in China and grown market share.

Domestic elevator companies, which only have 20% market share, have weak sales and no margin. Production at one plant we visited is down 50% in 2014. It appears that international brands have maintained sales by taking further market share from domestic brands by price discounting this year.

Chart 3. Market Share by Manufacturer in Elevator Units



Source: J Capital Estimates, Company Reports

Sales channels: agents and distributors dominate

Distributors and agents dominate sales, making up 85-90% of all elevator sales. Distributors finance sales. Agents get commission. High-end elevators have a unit price typically more than RMB 400,000, and low-end elevators start at around RMB 150,000.

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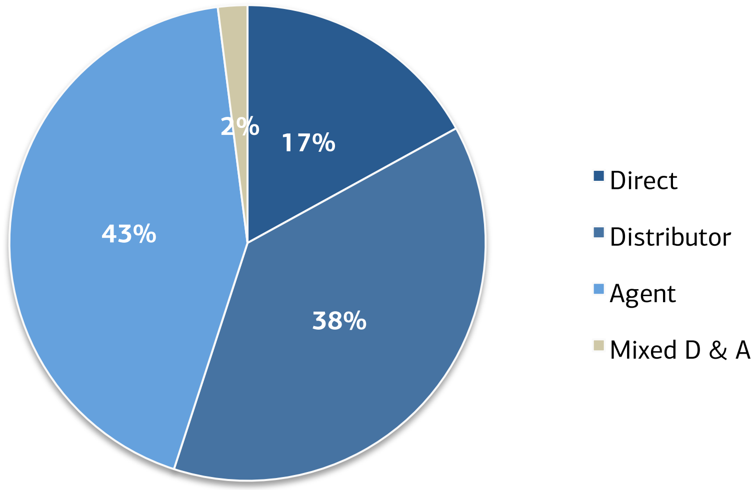
Chart 4. Elevator New Equipment Sales Channels



Source: China Elevator Association

Payment terms in China

Typically, a customer will pay a 20-30% deposit when ordering an elevator. Otis, Mitsubishi, and Schindler require a 30% deposit; Kone, ThyssenKrupp, and Hitachi require a 20% deposit. A further 65-75% will be paid before delivery and installation in two phases, when manufacturing commences and then just prior to installation. A final 5% is paid following installation. The payment of the last 5% is often delayed by up to three months. There is no penalty for delaying an order, however, if you cancel, the deposit is not refunded. Some elevator companies may charge a storage fee of RMB 30-100/day on a delayed order.

Elevator sales in construction cycle

Elevators are installed around halfway through building construction. Most tall buildings in China take two years to construct, and we estimate that elevators are installed at the end of the first year, when the core construction of the building is completed (topped out). Elevator sales lag the market by six to 12 months. When markets turn down, there will be a delayed reaction in elevator sales.

Maintenance sales

Elevators are typically sold bundled with the first year of maintenance. After the first year, the property manager will put the maintenance contract out for tender. Maintenance margins are negative or low for residential. The annual contract in a low-

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end residential building can be as low as RMB 2,000-3,000. The best margin is in the high-end office buildings. The key manufacturers with the best retention of service contracts are Kone, with 50% retention, Otis with 40%, and Mitsubishi, with 20%.

Maintenance is a much more important market in a mature market, making up more than 50% of sales in Europe, where retention rates are 85% and where maintenance is higher-margin than new equipment. In China, new equipment sales dominate, with maintenance comprising only 10% of the market. This is partly because it is a growth market but equally because the market is highly fragmented and there is intense competition suppressing prices and margin.

Overcapacity

There is extreme overcapacity and oversupply that have led to intense price competition. This is pushing down price and margins. There are eight major competitors in the China market. Each construction project would receive around 20 competitive tenders for elevators. Elevator prices have been declining by 5% a year in recent years. Mitsubishi's high-end imported elevators are the exception, having successfully raised prices 5-7% in 2014.

Otis' main manufacturing plant in Tianjin does not make a profit from new equipment: it makes its margin from the sale of parts and maintenance of high-end elevators in office buildings.

Table 4. China Growth and Margin 1H 2014

Company	Growth In China Rev	Margin Est.	Margin Trend
United Tech (OTIS)	6-7%	20%	Flat
Mitsubishi	10%	6%	Down from 8%
Hitachi	10%	5-6%	Flat
Schindler	10%	10%	Down from 12%
KONE OYJ-B	15%	14%	Flat
ThyssenKrupp	10%	11%	Flat

Source: Company Reports, J Capital estimates

China construction turns down

A correction in the property market has been under way since the beginning of the year. No longer perceived as a good investment, property sales and prices have slumped. Growth in new starts growth is negative. Competition is up, adding to the excess

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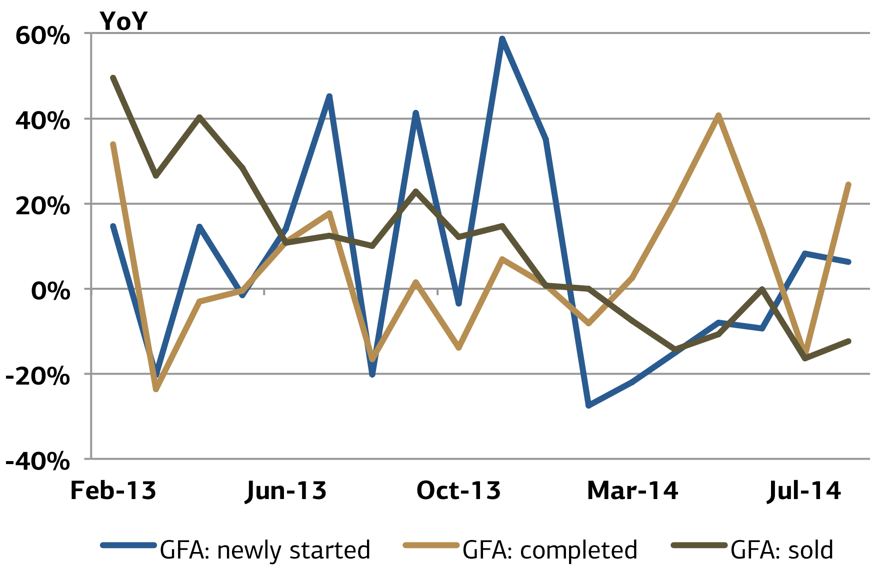
supply. Demand for building materials is falling, as less new construction is replacing completed buildings. Elevators sales are lagging this decline in construction.

China new starts in construction have been negative for five consecutive months this year just as in 2008/9 and 2012. New starts growth can be erratic and misleading, partly because it is a bureaucratic definition and not the true start of construction. However, five consecutive months of negative growth has always led to a severe downturn in construction. Our own primary research reveals for both construction steel and cement sales that property construction is down nationally by as much as 20-30% in the worst regions.

Elevators are installed about 12 months after construction starts. We expect elevator sales to fall by about 20% in 2015, mirroring the fall in starts in 2014, and property construction to be down 20% as well.

Slowdowns in elevator sales tend to accelerate in a construction downturn, because developers cancel orders. For that reason, we expect the time lag between the decline in starts and the decline in elevator orders to tighten.

Chart 5. China Property Construction



Source: Wind, NBS

Real estate investment growth is now 10% compared with 20% last year, while real estate sales are down around 10-20% this year. Inventory of completed apartments is high and rising, as completion rates are greater than new starts. This is pushing prices down. Consumers no longer believe investing in property

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will lead to good returns. The nexus of growth is broken.

The decline in pre-sales

Historically, developers depend on pre-sales as a key source of funding, typically for 30% of funding. Presales growth has been negative all year, and the NBS reports that pre-sales now account for only 23% of developer finance, raising financing costs and putting further strain on cash flow.

The Hong Kong effect

We expect the Hong Kong protests will accelerate the downturn for the following reasons:

- The government may divert capital into Hong Kong property and equity markets
- Confidence will weaken, making it harder for Hong Kong listed developers to access capital
- The inevitable reduction in commercial property revenues will drag down developers exposed to commercial property.
- Instability raises the risk of a wild-card event.

Kone's business in China

Kone has two production facilities in China, the major facility under the Kone brand and the second facility under GiantKone. GiantKone makes lower-end elevators targeting sectors such as social housing.

Kone new equipment sales are 40% to commercial, 60% to residential, with 50% of residential being social housing. Maintenance is only around 10% of sales in China.

Table 5. Kone Elevator Prices RMB/Unit

Elevator	Kone	GiantKone
10 Storey	200,000	185,000
30 Storey	365,000	285,000

Source: J Capital, Interviews

Kone first acquired a 40% stake in Giant Elevators in February 2005 and later increased its holding to 80%, in May 2011. At the time of investment, Giant sold 1,100 units/year and had an installed base of 2,500 units. By 2011, we estimate that it was

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selling around 10,500 units/year, and in 2013, we estimate that had grown to 28,000 units and will be around 35,000 units in 2014. EBIT margin of GiantKone was 14% at the time of acquisition.

The acquisition of the additional 40% of GiantKone enabled the consolidation of the total sales of GiantKone into the parent company accounts for the first full year in 2012. Consolidating this entity into its accounts was equivalent to two-thirds of the sales growth in 2012. The acquisition was a key driver of growth for Kone sales in 2012, which otherwise would have seen sales growth in China shrink to 6% rather than the 26% reported.

Kone outsources 70-80% of production to private companies. Kone manufacture the key components such as the control systems and the stainless steel doors and elevator casing.

Kone Factory Kunshan April 2013 Photo: People's Daily

Market conditions and Kone sales in 2014

Clearly, property markets are undergoing a correction, and construction is declining. What is surprising is the relatively good results reported by elevator manufactures for China sales so far in 2014. Growth has halved, from around 20% to 10%, but that is still good growth. Our checks indicate that growth in sales will turn negative in Q4 2014 and this will continue into 2015. We expect Kone growth to fall from 1H 2014 15% to around 7-10% for the full year.

We estimated Kone's regional sales and conducted telephone and face-to-face interviews with 25 industry participants in 11 provinces to estimate sales in those regions. Kone does not release regional sales, but we used total regional elevator sales from the NBS and the map of Kone offices to estimate the company's regional sales.

Table 6. Kone Sales 2014

Regions	% Kone Sales	Kone Growth	Order Delay	Kone	Competitor	4Q Sales	2015
East China (Shanghai, Zhejiang, Jiangsu)	45%	10%	5%		TK growth 20%, Hitachi 10%, Mitsubishi 10%	Flat	Down
Central China (Chongqing, Shaanxi, Hubei)	15%	10%	5%	Social housing is 20% of sales and key growth area		Flat	Down
South China (Guangdong, Fujian)	10%	5%	2%		Otis growth 0%	Flat	Down
North China (Beijing, Tianjin, Hebei, Liaoning)	10%	5%	5%	Good sales to office buildings as price is low	Mitsubishi, TK and Kone sales down in Tianjin, Shenyang and Shijiazhuang	Flat	Down
Other Areas (Hunan, Shandong, Shanxi, Xinjiang)	20%	0%	30%	Sales to social housing mixed, good in Xinjiang, none in Shanxi, limited sales to offices and retail	Social housing is key in these regions 30 - 40% of sales,	Down	Down

Source: J Capital

At Kone's recent investor day, the company stated that the total market for elevators in China grew at 10% in the 1H 2014 and its own sales grew at 15%. Our checks are showing that 3Q slowed, and most respondents in core Kone markets told us that the company's sales were up about 10% YTD. All regions are expecting flat sales, except for the non-core areas, where sales will decline. Almost every respondent expected sales to fall in 2015.

Elevator sales to social housing were cited by respondents as one of the few growth areas for Kone. Social housing elevator sales have intense competition, lower prices and margins. Kone flagged possible declines in this segment at its recent investor day.

Kone emphasized that growth is very varied within a single province of China and our research confirms this trend. Jiangsu

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has some cities with elevator sales still running at 30% and others with negative growth. We found other provinces with similar regional disparities. Kone sees this as a market still with opportunities; we see it as a market with dominos falling.

Delayed backorders a signal of sales decline

We had expected to find that manufactures to reduce deposit requirement to boost sales. We found almost no evidence that was the case. Instead we found widespread delays in orders. We have heard estimates that up to 50% of orders in 1H 2014 have been delayed. Order delays in recent years have typically been less than 2%. The inventory at some elevator manufacturers has been described as "a mountain of inventory." Specifically, Mitsubishi's Shanghai factory has high inventory levels due to 20% of 2013 orders being delayed in 1H 2014. Otis's Hangzhou Xiao factory also has very high inventory, and it is estimated that 30-40% of 2013 orders were delayed in 1H 2014. Kone does not have a high level of inventory. This is attributed to the fact that Kone's strategy is to outsource the manufacturing as far as possible. Kone's delayed orders in peripheral markets are high at around 30%. In core markets it is more like 5% and we estimate an average of 10%

Distributors tell us that Otis is selling some new equipment below cost in order to bundle with three-to-five year maintenance contracts. This is said to be mainly for high-end office buildings.

Catalysts: Why short now?

It is clear from our checks that sales will start declining in 4Q 2014 in China and this decline will accelerate in 1H 2015. Any upturn in property investment and construction now cannot arrest the decline in sales in 1H 2015. At best, an improvement now could see 2H 2015 sales return to growth. If that happens, it will be clear in 1H 2015. We expect that poor sales reports from the company would lag improvement in the market and provide a good opportunity to exit a short position if there is an upturn.

We expect Kone sales growth in China to fall from 15% 1H 2014 to 9-10% for 2014. Kone forecasts sales growth in the range 6-9%, we expect it will disappoint the market with growth of 5% and a 1% point decrease in net margin.

What would change our minds?

Growth in new construction starts, while down YTD, have been positive YoY for the most recent two reported months of July and

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August. If this trend continues through to the end of the year and we see improvement in construction material demand for steel and cement then we would change our mind. This would indicate that Kone will most likely see a brief downturn in sales before returning to growth.

Scenarios

Table 7. Scenario Valuations

Scenario	Price
Best	28.82
Base	25.70
Worst	24.30

Source: J Capital

Best Case

China growth is flat, margins fall by 1% point and rest of the business grows at 3%. China flat growth assumes that there will be strong growth in the 2H 2015 as it is clear from the downturn in construction in 2014 that 1H 2015 will deliver negative growth.

Worst Case

China growth falls by 30% rather 20% as property markets seize up.

Table 8. Revenue and Net Profit Scenarios

Scenario	2014	2015	2016	2017
Best				
Revenue	7,265	7,415	7,570	7,797
Net Profit	701	714	728	751
Base				
Revenue	7,265	6,962	6,754	6,956
Net Profit	701	615	598	670
Worst				
Revenue	7,265	6,735	6,414	6,606
Net Profit	701	543	519	637

Source: J Capital

Valuation: DCF PT Euro 25.70 Downside 19%

Our target price, using our base case scenario, assumes China sales fall 20% net margin will fall by 2% points in 2015 and continues to fall in 2016 before growing again in 2017. Sales

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grow in the rest of the business is assumed constant at 3%. We use a weighted cost of capital of 8.9% and assumed a terminal growth rate of 3% and terminal value is 65% of the valuation.

Risks

China successfully stimulates the property sector, investor confidence in property returns and property construction grows.

Europe or the Americas have higher than expected growth.

Higher level of government regulation of elevators leads to higher growth in maintenance revenue and margins.

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