Europe | Machinery

Kone Corporation (KNEBV FH)

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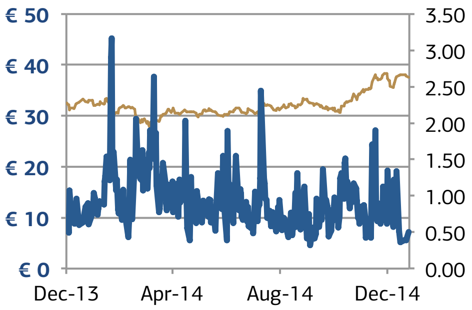
Better than expected

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



Source: Bloomberg

Kone (KNEBV FH)

Price	EUR 37.59
Rating	**SELL**
Price target	**EUR 27.53**
Difference	**27%**
Market Cap	EUR 16.89 bln
Simple Moving Avg.	776,881
P/E	29.97x

Source: Bloomberg

+ Q3 sales outpeformed expectations

Kone sales were expected to be good in the third quarter, but the 20% clocked was a surprise to the upside. Only Otis reported sales flat, with most brands reporting 5–20% sales growth. The drive came from improved market liquidty, which drove higher completions. But it is a mixed blessing for elevators: developers are getting much less from pre-sales and are rushing to complete anything they can sell, usually at a discount, in order to recoup cash. That means less new property in the pipeline.

+ Q4 sales growth to slow to 14%

Our checks indicate that Kone sales growth will fall to 14%, higher than the guidance of the company of around 10%. Kone, which focuses on the low-end market, seems to have gotten an extra push from the money released in H2 2014 for public projects. This is wearing off quickly. We expect elevator sales in China to be around 7% in 4Q.

– Kone sales to contract 10% in 2015

Our checks indicate that Kone sales will fall by 10% in 2015, while Kone is estimating sales growth of around 10%. Competitors are expecting sales growth of 5-10%, and the China Elevator Association is predicting flat sales for the year. We believe that completion rates will slow, as the downturn in new starts flows through and financial distress increases for developers. Kone may be reacting to unusually positive sentiment following government policy support for real estate, which led to a short-term increase in sales.

– Valuation: PT EUR 27.53

We have increased our base case target price, using DCF, from EUR 25.70 to EUR 27.53. Our base case scenario has Kone elevator sales in China falling 10% in 2015 and 2016, and margin falling by 2% before returning to modest growth in 2017.

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Elevator Sales Peaking

We were surprised by Kone's 20% sales growth in Q3. There has clearly been an improvement in liquidity for property developers and thus in property sentiment since our first elevator survey in August this year. At that time, property sales and completions had plunged and sentiment was at a low. Our most recent checks in the first week of December indicate that sales will continue to grow in the fourth quarter before turning down in 2015. We still believe that the slowdown in the property market will hit elevator sales in the first half of 2015. We have revised our forecast from a contraction of 20% to a contraction of 10% in Kone sales.

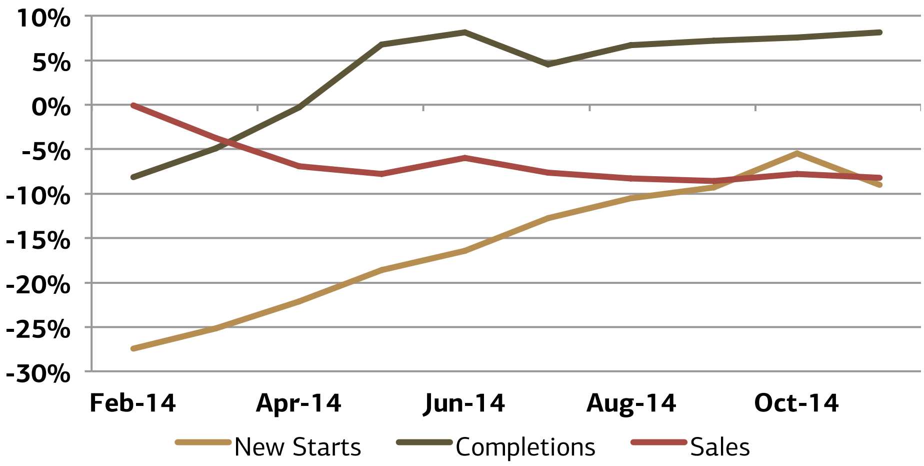
Property and construction

A rush to recoup on rising costs drove completions in 2014. But starts are way down.

In 2014, construction new starts are down and completions are up. NBS data have new starts down 9% YTD through November, the largest decline in over a decade. Our own surveys of developers, steel traders, and cement companies indicate that new starts may actually be down by much more, perhaps 20% through November.

Completions, on the other hand, were up 8% through November, much higher than the meager 3% growth for the same period in 2013. Completions drive elevator sales.

Chart 1. Property Construction and Sales 2014 through November YTD



Source: NBS

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Pre-sales, accounting for around 25% of developer funding, shrank by 14% in 2014, and that is a critical spur to higher costs of financing for developers in 2014. Local developers no longer have access to bank loans and are increasingly funded by high-interest loans from shadow banks. Developers are focusing their resources on completing buildings in order to recoup investments. This is the key driving force behind rising elevator sales. Developers are less able and willing to purchase land and to start new construction in a market that has excessive inventory. Most of a developer's equity is used in land purchases, which is recouped when completed developments are sold.

PBOC pushed liquidity into banks in the second half, and that drove higher completions. But the pipeline has narrowed, as developers are buying less land and starting fewer projects.

Recent policy changes improved sentiment and MoM sales in October and November. Policy changes included the removal of restrictions on purchasing additional properties, allowed mortgages on second homes and the discounting of mortgage rates. This came at the same time as monetary authorities pushed further liquidity into the banking system.

Positive effects already gone?

Although data sets are contradictory, we believe that the positive effect on sentiment ended in December. No matter what, the policies will not change the fundamental problem of excess inventory in the market. We believe inventory is anywhere from two to seven years of sales at current sales rates in most cities in China.

The slowdown in new starts began in H1 2014 and will inevitably be reflected in lower completion rates in 2015 and a fall in demand for elevators from as early as Q1 2015.

Cement sales show declining construction

Cement sales declined in November for the third month in a row for the first time since the late 1990s. November cement sales were down sequentially and year on year. This should be a peak sales period for cement. Cement sales have been weak in the North and Northeast, down 14% and 20% respectively. November saw sales in the key markets of Central and East China down by 2.7% and 2.3% respectively. Guangdong, one of the best cement markets, has growth of 1.7% through November compared with 14.7% for the same period of 2013. We know from our cement surveys that infrastructure demand has been driving cement sales. It is clear that demand from residential property construction is dragging down cement sales.

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Survey results

Our survey in December indicates that Kone sales were likely to grow 14% in the last quarter of 2014 before declining in 2015. We interviewed 12 agents, distributors, and manufacturers of elevators and escalators in seven provinces. At the time of our last survey, in August, we had expected flat sales for the fourth quarter and declining sales in 2015.

The construction market gives us the most unvarnished view of property.

Table 1. Kone China Sales Survey December 2014

Province	% Total Elv Mkt	4Q Sales	2015 Sales	Order Delays	Survey Notes
Yunnan	7%	Flat	Down	30%	Kone taking market share, Receivables rising at distributors
Sichuan	8%	Up 15%	Down	40%	Deliveries slowing in 4Q a bad sign for 2015 sales, payments slowing
Beijing	6%	Up 10%	No Resp	No resp	
Zhejiang	9%	Up 20%	Down	10%	Kone taking market share, Mitsubishi, Otis and Hitachi sales down 20%
Guizhou	3%	Flat	Down	40%	80% of payments delayed
Guangdong	12%	Up 16%	2-5%	5%	Customers placing orders later
Jiangsu	9%	Up 20%	2-5%	25%	Receivables up from 30 to 60 days, customers placing orders later
Average Weighted		Up 14%	5% Down		

Source: J Capital Research

Most respondents said that Kone is selling to mid- and low-tier residential projects and that it has weak sales to commercial buildings. This was also confirmed by a common comment that sales of Kone escalators are not as good as for Schindler escalators.

Escalator sales falling rapidly

Our checks indicate that Kone escalator sales will fall by around 40% next year. Escalators are around 7% of Kone's sales in China. From this survey we estimate that Kone China sales will decrease by 8–10% next year.

The China Elevator Association is predicting that China sales will be flat in 2015 for the first time since 2009.

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Government procurement

Government procurement of elevators for infrastructure projects such as high speed rail, metro systems, hospitals and social housing accounts for about 6% of the market in China and grew at 27% in 2013. Government procurement sales hit a low in September this year and then bounced back strongly in October. October sales were up 24% MoM and 16% YTD. This reflects our view that funding of government infrastructure projects in improved in October.

Kone got a boost from selling into social housing but this segment will decline rapidly in 2015.

Competitor performance in China

Table 2. Elevator Company China Sales Forecast

Company	4Q	2015
Kone	10%*	10%*
Schindler	7%	6%
Otis	0%	10%
ThyssenKrupp	8%	6%
Mitsubishi	5%	5%*
Hitachi	6%	5%*
Canny	20%*	15%*
Shenyang Brilliance	10%*	
SJEC	10%*	

Source: Company Reports, *J Capital Estimates from Reports

Schindler

Schindler has held its outlook for China sales to 7% growth in 2014 and falling to 6% for 2015. Schindler consolidated XJ Schindler accounts as of mid August 2014. Without that consolidation, growth would more than likely be closer to 5% in 2014 and 4% in 2015.

Schindler sales are the lowest of all the international brands in China. Schindler is best regarded for escalators and not elevators.

Schindler CEO Silvio Napoli recently stated that he plans to overtake Kone and Otis in China by increasing production capacity, lowering prices and reducing costs. It seems that every major international brand has the same aspiration. A price war could be a feature of 2015. In the same Bloomberg interview, Mr. Napoli, said he will focus on Mongolia and Kazakhstan. Combined, they may have the same number of elevators as Nepal has.

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Otis

Otis has had no growth in sales since Q1 2014 but claims that new orders were up 14% for the first three quarters of 2014. Those orders would deliver at least 7% sales growth in 2015; Otis projects 10%. However, our checks indicate that Otis sales are in decline and that the company has yet to fully recover from the impact of widely reported accidents in 2012.

ThyssenKrupp

China orders and sales for 2014 were both up 8%. The company is forecasting sales growth falling to 6%. Consolidation of the earlier 25% investment in Marohn may have artificially distorted these numbers. ThyssenKrupp services high-end office, hotel, and commercial properties.

Mitsubishi, Hitachi and Toshiba

Together, these three companies have nearly 30% of the market in China. All three are part of conglomerates and reported information is thin. From our reports and checks we estimate the sales of these three have been in the range of 5-10%, with Mitsubishi closer to 10% Hitachi around 6% and Toshiba around 5%. Mitsubishi is widely regarded as a market-leading brand. Mitsubishi has refused to engage in a price war and has even increased prices for its higher-end imported products. This has seen Mitsubishi lose market share, mainly to Kone.

Domestic brands

Canny has been the stand-out performer in China, with around 20% sales growth this year. Shenyang Brilliance and SJEC grew around 10%. Together, these three brands would make up about 5% of the China elevator market. If we are to believe these companies, then the foreign brands are not taking market share from them. We estimate that the remaining 15% of the market that is supplied by domestic brands have seen sales decline by around 15-20%. One small domestic company told us that they compete on price and will accept a gross profit of RMB 10,000/elevator compared with RMB 60,000/elevator for a foreign brand.

Bear case and bull case

We believe sentiment is overly optimistic and sales could decline further.

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- Property sales may decline further and more local developers go bankrupt.

- Accounts receivable are rising in the elevator sector. Manufacturers isolate themselves from receivables by making most sales, at least 80%, via agents, so there is a delay in receivable build-up in the elevator companies. It is now possible that distributors may collapse next year, causing steeper declines in Kone's sales.

- Order delays are rising and are greater than 25% in all but the best markets, such as Guangdong. Increasing order delay is a strong indication that 2015 sales will turn down.

Toshiba Elevators wharehouse in Shenyang full of inventory most likely due to delayed orders | J Capital Nov 2014

Watch for the failure of property-backed WMPs.

On the upside, Kone sales may do better than we expect for the following reasons:

- Kone has a winning strategy of the lowest pricing strategy of the top-tier brands, coupled with excellent cost control.

- Kone has been taking market share successfully from competitors, particularly Otis and less so Mitsubishi. The market is fragmented, and the low price strategy was successful in 2014.

- A blind spot for our research is elevator manufacturer direct sales to the large property developers. Kone states that direct sales are one-third of the total, and we have modeled in the company's own projections, as we have

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limited ability to measure these sales. Direct sales would be to the financially strongest developers, as Kone wants to maintain a good relationship with them.

- The company is focused on expanding the services portion of its China business and on modernization or elevator replacement. Service is only around 10% of the market in China and, in the categories where Kone leads, margins are reported to be thin.

DCF Valuation TP of EUR 27.53

We have increased our base case target price from EUR 25.70 to EUR 27.53. Our base case scenario has Kone elevator sales in China falling 10% in 2015 and 2016, and margin falling by 2% points before returning to modest growth in 2017.

Our best case has flat growth and stable margins in China and our worst-case sales decline of 20% and margin falling by 2%.

Table 3. Target Price

Scenario	Price
Best Case	29.55
Base Case	27.53
Worse Case	25.96

Source: J Capital

Table 4. Kone revenue and net profit scenarios

Scenario	2014	2015	2016	2017
Best				
Revenue	7,265	7,265	7,265	7,483
Net Profit	701	698	698	721
Base				
Revenue	7,265	7,047	6,836	7,041
Net Profit	701	623	605	626
Worst				
Revenue	7,265	6,829	6,420	6,612
Net Profit	701	602	567	589

Source: J Capital

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