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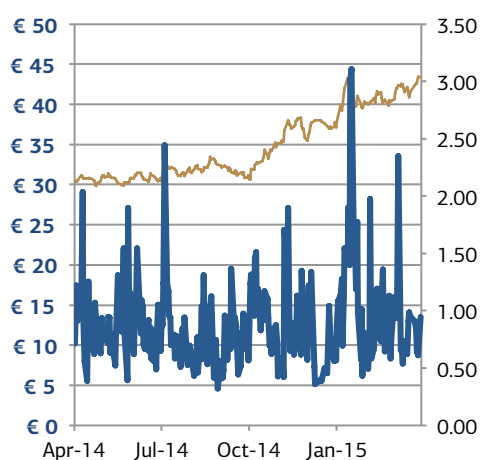
Asia Pacific | Machinery

# Kone Corporation (KNEBV FH)

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## Q1 Sales Survey

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



Source: Bloomberg

### Company (Ticker)

Price	EU43.24
Rating	<b>SELL</b>
Price target	<b>EU25.70</b>
Difference	<b>41%</b>
Market Cap	22.68 bln
Simple Moving Avg.	36.39 mln
P/E	29.22

Source: Bloomberg

### + Kone China Sales up 5% in Q1. East China the key

We remain convinced there will be a sharp downturn in Kone sales in 2015. We had expected to see a clear downturn in Q1 and now expect the downturn in Q2 2015. Kone's core East China market is the last penny to drop and is the key market to monitor. Kone continues to see sales growth in East China.

#### - Still some growth in core China markets

Ahead of the Kone Q1 Earnings report (release 22 April) we conducted a survey on Kone Q1 sales. We found weaker, less important markets like North East China, South West and West China have seen sales falling by 5-30% in Q1. There is still some growth in core markets in East China, which has been supporting Kone's sales. Zhejiang has seen sales increase 10-15% and Henan is up 20% in Q1. Sales in Jiangsu, however, have fallen around 10%. These two provinces make up 18-20% of Kone's sales.

#### - Completions data trending down

Completions data has been down for two consecutive months, -12.5% in February and -8% in March. The core East China market of Zhejiang tanked from a growth rate of 40% in 2014 to -9% in February. This gives us greater confidence that we are likely seeing the last quarter of growth for Kone.

#### - Pricing wars may have started

Kone's strategy has been to take market share from competitors using lower pricing. Kone has been taking market share from the well established Mitsubishi. Now, Mitsubishi has begun to drop prices in Kone's best market, Zhejiang Province. Kone success at taking market share may start to reverse or see further decline in margins. We have seen discounting of 3% in Kone's weaker markets

#### - Price target EU25.70 Sell Unchanged

Our target price calculated using DCF remains unchanged.

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## Kone Sales Still Growing

East China accounts for 45% of Kone's sales and grew 10% over Q1. Peripheral markets like North East, South West and Central China accounting for around 25% of sales saw sales decline 5 – 30%. We estimate Kone sales in Q1 will be up 5%.

The outlook for sales in the regions where sales were falling is for that trend to continue. For the areas where sales are good the expectation is that sales will peak in Q2 before falling in 2H. Orders and payment delays increased in areas where sales declined. Order delays improved in Zhejiang province in East China but increased in neighboring Jiangsu. Payments delays are becoming a larger problem in both provinces. We see this as a key warning sign of the market peaking in East China.

Kone sales have been strongest to mid to high end residential. Sales to social housing and low end have been poor. Escalator sales, around 7% of Kone sales in China have fallen 30-40% as we expected.

We completed a telephone survey of 13 Kone sales representatives across China in late March early April to understand Kone sales in Q1 2015. Key results are in the table on the following page:

**Table 1. Kone Sales**

Province	Q1 Orders	Q1 Sales	Outlook Q2	Q1 Order Delays	Q1 Payments
Zhejiang 1, East China	Up 10-15%	No Response	No Response	Improved from 20-30% to none	Large problem no improvement
Zhejiang 2, East China	Up 10%	No Response	Up more than 10% but then down in 2H	None, unchanged	Large problem and worse
Jiangsu 1, East China	Flat	No Response	Flat	Increased from 20% to 30%	Stable at 25-30% of sales
Jiangsu 2, East China	Down 10-20%	No Response	No Response	Increased from 10-25%	Increased from 10-30%
Heilongjiang, North China	Down -5%	Down -5%	Flat	None, unchanged	No delays
Liaoning 1, North China	Down 5-10%	Down 5-10%	No Response	No Response	Bad but improving
Liaoning 2, North China	Down 25%	Down 25%	Down	No Response	No Response
Liaoning 3, North China	Down 30-50%	No Response	Down	None, unchanged	Delays just started to be a problem
Jilin, North China	Flat	Flat	No Response	Up from 10% to 30% orders	Deteriorated from 10% to 20% of sales
Shaanxi, Central China	Down 25%	Down 25%	Down	None, unchanged	No Response
Henan, Central China	Up 20%	Up 15-20%	Up 20%	Improved from 40-50% of orders to 20%	Improved from 10% to 5% sales
Hubei, Central China	Flat	Flat	Up 10-20%	No Response	Improved
Yunnan, South China	Down 20-30%	Flat	Down 30%	Delays stable at 15%	Worse 30-40% of sales

Source: J Cap phone interviews Mar 25 – Apr 7 2015

### Survey Response Highlights

#### Jiaxing, Zhejiang (good sales)

- **Government sales not good, residential good:** Sales to government projects like social housing, administrative buildings, and hospitals were not so good. The best sales were to residential property developments. Jiaxing is seeing new starts and completions grow.
- **Sales to high-grade office buildings have not been good.** We made good sales to the new train station, which is only using KONE elevators. Mitsubishi sales volume is higher than ours but Hitachi is less.

#### Jinhua, Zhejiang (good sales)

- **Deteriorating environment:** The current environment is a serious deterioration of the situation in real estate. Weak developers are at a standstill, and only the strong developers will survive. **In these circumstances Mitsubishi and Hitachi will suffer the most.** Kone still has relatively stable sales growth.
- **Developers:** Big developers are completing projects but smaller local developers have all stopped construction. **The volume of completions is definitely falling.**
- **Expect 2H to go down:** Despite new positive government policy supporting real estate we expect 2H will go down. Mitsubishi and Hitachi are finding it very hard to get orders.
- **Stable prices:** Our prices are stable and we cannot give discounts for signing longer maintenance contracts.
- **Resi sales:** Most sales are to residential developments with slightly higher end residential being the best sales. Almost no sales to public projects like hospitals.
- **Escalators:** Escalator sales have fallen 10% this year but only make up about 3 – 4% of sales. Most escalator sales are to shopping malls and there have been **very few shopping mall completions** recently.
- **Mitsubishi and Hitachi sales declined 30 percent last year,** this year should also continue to decline.

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- **Brand shift:** There appears to be a shift from 1<sup>st</sup> tier brands to 2<sup>nd</sup> Tier brands. Otis sales from its' Xizi joint venture saw sales increase 20% last year and we expect it to maintain that growth this year. Xizi is a Zhejiang province brand and so sales have always been good in this area. When the market is good developers will choose high end brands and when it is not they will choose the most cost effective brand.

### Suzhou, Jiangsu (flat sales)

- Completions are good in Suzhou but that was last year's sales.
- **Our prices remain unchanged.** We are not lowering prices for longer maintenance contracts. Equipment has profit and maintenance does not. We have many quality complaints.

### Yangzhou, Jiangsu (poor sales)

- **Delayed completions:** Developers are delaying completions as there is so much excess inventory of residential apartments.
- **Poor sales to local infrastructure projects** as the locally produced Samsung elevators are preferred by the local government.
- **Escalator sales have been good** as many shopping malls have been completed.
- **Mitsubishi and Hitachi have lost market share to Kone** in recent years. They have lowered their prices below Kone to take market share. This year they plan to achieve 10% sales growth.

### Harbin, Heilongjiang (poor sales)

Current policy easing will have little to no effect in Harbin as there is so much excess inventory. Real estate is no obvious increase in completed projects. We are making almost no sales to office buildings and shopping centers.

### Shenyang Liaoning (poor sales)

- **Completions are decreasing.** Most projects that are nearing completion are large national developers like Poly and Wanda. They negotiate with the head office so there are few sales for us.

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- **Prices have fallen to cost for some projects.** We are not discounting maintenance contracts. Escalator sales are poor.
  - **Sales target lower:** Our sales target this year is 10-15% less than last year.

### Dalian, Liaoning (poor sales)

- **Mild pick-up:** There has been a pick-up in real estate transactions but it is mild.
- Large developers are okay but small developers are not doing well.

### Jilin, Jilin (poor sales)

- **Sales fudging:** A lot of Kone sales branches hold sales from last year and record them in this year. So some of the sales now may not reflect real sales now.
- **Low expectations:** We expect this year to be worse than last year. Real estate is not doing well. Local real estate developers completions went down 25% -30% last year.
- **Price cuts:** We have lowered prices by 3% but are not giving discounts for longer maintenance contracts as the company is concerned about labor cost inflation in the long term.
- **Escalators poor:** Escalator sales are down more than 50%. Escalators make up 20% of all sales.
- **Mid-high-end resi key:** Residential property developments that are mid-to-high-end are the key source of our sales. We also sell to public infrastrucrue projects, office buildings and shopping malls.

### Xian, Shaanxi (poor sales)

- **Lower expectations:** We are negotiating some big project sales for the second quarte,r but we still feel it will be down on last year. Overall this year's sales will be down on last year.
- **Escalators, office shopping centers poor:** Escalator sales are poor this year. Mainly selling to residential. There are few sales to office buildings and shopping centers.

### Zhengzhou, Henan (good sales)

- **Elevator prices up:** Elevator prices in Zhengzhou, the provincial capital, have gone up, but in the lower tier cities they have gone down by several thousand RMB.
- In general we can provide lower new equipment prices if the customer is willing to commit to a longer maintenance contract.

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- **Discounts:** We have provided discounts of RMB10,000 lower than Mitsubishi to developers purchasing large quantities of 500 units. That developer got together with other developers to get to 500 units.
  - **High-end residential and office sales:** Most sales to high-end residential and office buildings, Zhengzhou Greenland Group development used Kone elevators.

Subway and hospital sales are not doing well.

- **Better than competitors:** Our sales have been better than Hitachi and Mitsubishi in recent years but our volume of sales still does not match them.

### Wuhan, Hubei (flat sales)

- **Prices are stable.** Give discounts to orders over 50 units. They are more focused on maintenance contracts, as that is where they are making more margin. If there is not enough profit in the maintenance contracts then we will not sign the contract.
- **Sales to office buildings and hotels are good.** Sales to low-end residential doing slightly worse and we made no sales to hospitals.

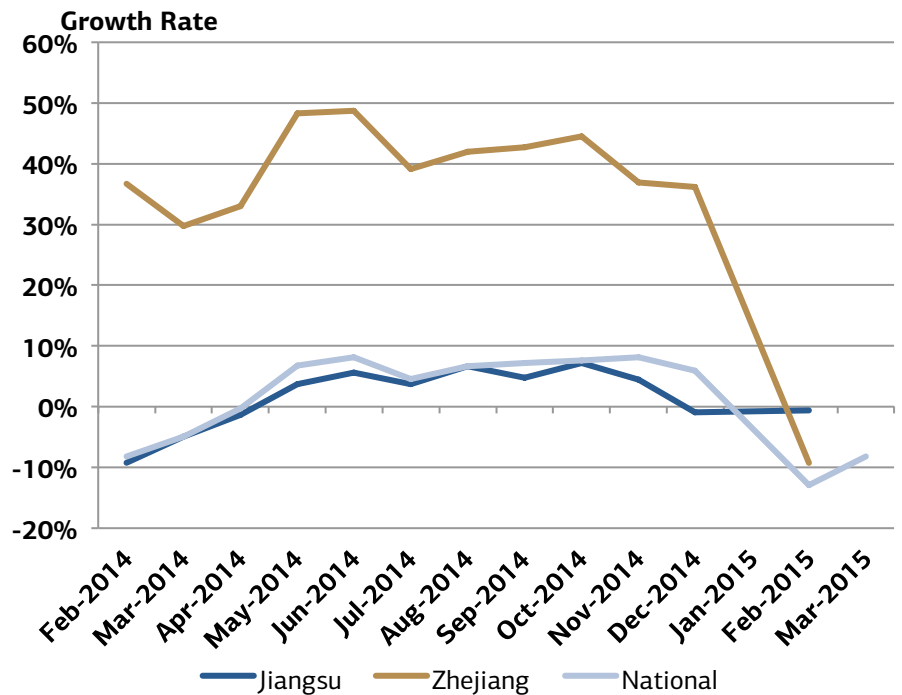
### Kunming, Yunnan (poor sales)

- **Few completions:** There are very few new building completions and the outlook is not great.
- **Pricing:** Have flexibility to provide discount if they can get a longer maintenance contract.
- **Sharp increase in complaints:** We have seen a sharp increase in quality complaints, an increase of around 20-30% each year. Our complaints line was always engaged so we had to buy a new telephone system.

## Completions trending down, focus on East China

National Property Completions data showed a sharp downturn YTD February of -12.5% and this was followed by -8% for March. We see this as the beginning of trend for this year of a contraction in completions, which supports our view that Kone sales are set to fall.

**Chart 1. Property Construction Completions**



Source: NBS, J Cap

Our survey of elevator sales indicates that completions have turned down in all areas we surveyed **except for East China**. When you look at completions data for Zhejiang and Jiangsu you can see that completions growth in Zhejiang has been far above the national average at around 40% in 2014. Zhejiang accounted for 6% of all completions in 2014, Jiangsu around 9%. Zhejiang fell sharply in February down 9%, while Jiangsu went flat. March data is yet to be released, however, we expect completions growth to be down in both provinces.

We believe local developers are financially constrained from completing property under construction and this is the key cause of completions decline. Survey respondents said that large developers were fairing okay and local developers were nearly all



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in trouble. We estimate in most markets large developers build around 80% of construction and local developers around 20%. We have been expecting this pattern of decline.

**The key to Kone sales is clearly what happens to property completions in East China.**

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