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Kone Corporation (KNEBV FH)
Dropping Through the Floor

Kone Sales Down 5-10% in Q2
Our survey of elevator distributors has seen elevator sales and orders turn down sharply in Q2 2015.

Residential Completions Down 16% YTD
Completions are down nationally 16% but in East and South China, the key markets that held up elevator sales in 2014, completions have turned down even more sharply. The decline is accelerating in May despite a pick up in real estate sales. Our checks of building materials leveraged to the completion cycle is showing sales down 20-30%. We estimate the total elevator market saw sales declines of 20% and the declines will accelerate.

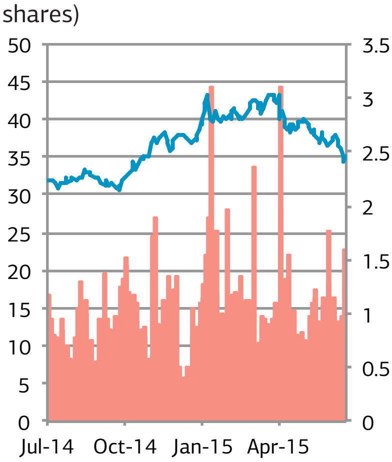
Order Lead Time Has Compressed
Elevator companies are not giving relief on order deposits and so developers are not making firm orders until just before delivery. Orders are now tracking sales.

Valuation EUR 25.70, Downside 27%
Our target price calculated using a DCF model remains unchanged.

Kone (KNEBV FH)

Price	EUR 35.14
Rating	**SELL**
Price Target	**EUR 25.70**
Difference	**27%**
Market Cap	18.5 bln
Avg. Volume	1.0 mln
P/E	23.6x

Kone (KNEBV FH) last share price in EUR (blue) and volume (pink, in mln shares)



Source: Bloomberg July 9, 2015

Kone China Sales Start a Long Decline

Kone will disappoint consensus in this quarter.

Kone China sales, which are 30% of total Kone sales, should show a Q2 decline of 5-10% (EUR 30-60 mln) for the first time since the Great Financial Crisis. Given our view that property construction will decline now for an extended period we expect elevator sales to follow. Kone will disappoint consensus in this quarter, and we expect this pattern to continue for the next year.

Residential Completions Plunge and Elevator Sales Follow

Completions, a lagging indicator of elevator sales, have turned down sharply in 2015 and are down 16% YTD. May saw the decline accelerate with YoY completions down 26%. Last year developers slowed new construction and pushed completions. This year developers are now slowing completions. Improved real estate transactions are not turning around this trend.

The key southern and eastern provinces, Guangdong and Zhejiang, which together account for 12% of the residential property construction market, delivered 78% of the growth in completions nationally in 2014. They have now turned down sharply, and this downturn is accelerating. Guangdong is down YTD through May 28% and 42% YoY in May. Zhejiang is down 21% YTD through May and 42% YoY in May.

Our property developer interviews indicate that smaller local developers led the decline in completions starting early last year. **Now it is the larger, national developers that are slowing completions, and those are the companies that drive sales for foreign-branded elevators, which will see a disproportionate hit this year.** International elevator brands were able to continue sales growth in 2014 as the local brands went into free fall.

Table 1. Residential Building Completions, Key Provinces

Province	Share of Residential Construction Market	Growth 2014	Growth YTD Through May-15	Growth YoY May-15
Jiangsu	9.0%	-4%	-6%	-7%
Shandong	7.5%	0%	8%	58%
Guangdong	6.7%	13%	-28%	-42%

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Zhejiang	5.1%	23%	-21%	-56%
Sichuan	4.8%	-4%	-16%	-28%
Anhui	4.7%	-2%	-7%	12%
Chongqing	3.4%	-3%	-15%	161%
Fujian	3.2%	9%	-14%	-5%
Beijing	2.2%	6%	18%	19%
Shanghai	1.9%	8%	22%	-67%
Nationally	100%	3%	-16%	-26%

Source: NBS

Improving sales led to increased completions in some regions in Beijing and Shanghai through April, but these markets saw sharp declines in May. Beijing and Shanghai are also small relative to the total market.

No Recovery This Year

There is little likelihood that the current downturn merely represents periodic volatility in the markets. Elevator sales depend on completions, and the outlook for completions is bleak. New starts have been down for the last 18 months and with average construction time just over 18 months completions are set to deteriorate further.

In fact, we have hard evidence completions will fall further. Suppliers of building materials such as copper wiring and plumbing, aluminum window frames and bathroom ceramics to late-stage construction are seeing sales down 10-30% nationally, with most down over 20%.

Furthermore, we believe that the decline in new starts understates the decline in new construction. Our checks with property developers nationally indicates that developers are starting construction on only 20-30% of approved construction area and waiting to see how sales progress before doing work on the remaining portion. Official “new starts” data is based on approvals and is therefore understating the level of decline in new construction.

Office Buildings and Infrastructure Holding Up

Office buildings, around 15% of elevator demand, is one of the bright spots for elevator sales, as office completions grew 11.6% through May. But new office starts are down just as much in the same period. This may be the last good quarter for office sales. We expect this segment will go into decline from Q3.

Infrastructure developments, particular rail and metro projects, have been going well in some areas but very few new projects have started. We see infrastructure completions slow in the second half. Distributors say their sales to infrastructure projects are a bright spot: ThyssenKrup has done particularly well, probably because of its national supply contract for high-speed rail terminals. Kone is making sales to infrastructure projects but is not the market leader in this channel. Infrastructure is around 10-12% of the elevator market. This segment is relatively better than others, however, we expect demand is flat in Q2 and most likely will fall in Q3 before rising again Q4 or Q1 2016.

Our Model Assumptions

Overall, we estimate that elevator sales are down 10-15% in Q2 and that Kone's China sales are down 5-10%, with orders down by similar amounts.

Prices are flat to down 10%. Leading brands like Mitsubishi are now discounting to hold or gain market share. Kone has generally not been reducing prices, but we expect that Kone has lost its key competitive price advantage and is unlikely to outperform the market.

Developers are cash-constrained and have become very cautious about ordering. Previously, a developer would order and pay a deposit of 20-30% when they commenced construction. Now they are placing an order just

Table 2. China Elevator Distributor Sales Q2

Province	Q2 Orders	Q2 Sales	Outlook Q3	Q2 Order Delays	Q2 Payments	Brand	Price	Sales
Guangzhou, South	-5%	-5%	-5%	Dramatic increase	Normal	Hitachi, Schindler, Dongzhi, Kone and local	-2%	Infrastructure good
Xiamen, South	Down	Down	Down	Increasing	Normal	Schindler and Giant Kone	-10%	Infrastructure poor
Wuxi, East	-15%	-15%	-15%	Orders late	Normal	Mitsubishi	-10%	Villa sales growth
Hefei, East	-10%	-9%	-9%	Orders late	Increasing delays	Kone	2%	
Hangzhou, East	Flat	Flat	-5%	Orders late	No response	Hitachi	No response	Renovation 5% of sales
Hangzhou, East	-5%	-5%	-5%	No response	Poor, paying 60% in apartments	Kuaike	No response	
Chengdu, West	Down	Flat	Down	Normal	Increased to 6 months	Kone, Hitachi	Flat	No new projects

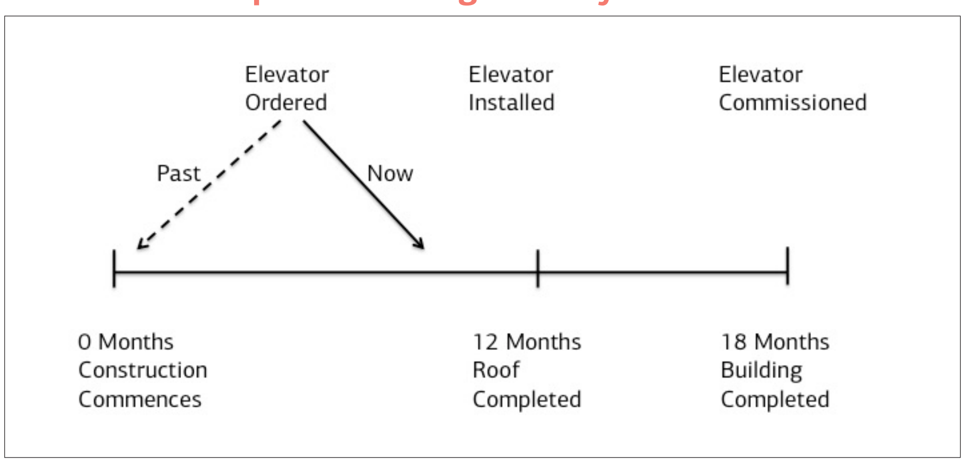
Chengdu, West	-50%	-10%	-20%	Normal	Normal	ThyssenKrupp	-2%	Infrastructure good
Xian, West	-33%	-60%	-50%	Orders late	No response	Kone	No response	
Xian, West	-30%	Flat	-50%	Orders late	Normal	Mitsubishi, Giant Kone, Xizi Otis	Flat	Renovation 5% of sales
Qingdao, North	-6%	-6%	-6%	Orders late	20% paid in apartments	Siemens	-10%	
Jinan, North	-20%	-30%	-30%	All orders delayed	From 5 to 45 days	ThyssenKrupp, Otis and Kone		No infrastructure sales

Source: J Capital interviews May, June 2015.

a month or two before requiring delivery. Essentially orders and sales are now occurring at the same time. Hence orders and sales are tracking in the same direction. We believe that Kone prepayments should fall by around 10-15% or EUR 200-300 mln by the end of the year as a result.

We have found that developers are not moving to lower-tier brands but are instead migrating to the lower-priced product within the brand portfolio of the leading elevator companies. This will drag on Kone margin and revenues.

Chart 1. Developers Ordering Late-Cycle



Source: J Capital

Developers are not moving to lower-tier elevator brands.

Kone is widely regarded to have excellent management and historically has clearly had the best strategy in China. However, this will not help Kone escape the collapsing property construction market in China.

Valuation

DCF EUR 25.70; Downside 28%. Our target price calculated using DCF remains unchanged.

Risks

1. Elevator manufacturers directly manage sales to many large property developers, and we do not have visibility into this channel. Sales made in this way could be as high as 25% of Kone sales. We estimate that this category of developer has performed relatively better than the overall market.

2. Strong fiscal and monetary policy, along with an under-performing stock market, could generate new interest in property and a short-term rebound in property completions. Halted projects could come back online quickly. This could see an elevator sales upswing.

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