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Kone Corporation (KNEBV FH)

China Sales to Fall 7% in H2

- **The demand growth from key accounts** that sustained Kone in the first half peaked in Q2 and is falling away, meaning that the company will see a 7% sales decline in China in H2 and 3% overall for 2015. In 2016, we expect that China sales will fall by more than 10%.

- **With Chinese residential property completions** down 17% YTD and accelerating, and new construction down 22%, we see only further weakening in the future of elevator sales. Improved property sales in Tiers 1-2 have not impacted construction.

- **Directionally, our survey of elevator companies** was uniformly negative.

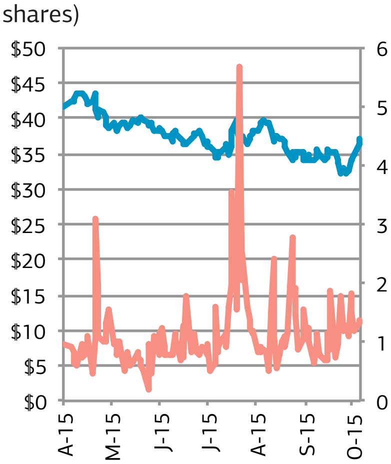
- **Kone sells to the best-performing** segment of the market, the listed property developers. Many of those clients continued to show growth in completions in the first half, and those accounts gave a boost to Kone's sales even as the rest of the elevator market went negative.

- **We raise our target price** from Euro 25.70 to 25.93 as we revise our sales decline in China from 10% to 3% for 2015.

Kone (KNEBV FH)

Price	Euro 37.40
Rating	**SELL**
Price Target	**Euro 25.93**
Difference	30%
Market Cap	Euro 19.5 bln
Avg. Volume	46 mln

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



Source: Bloomberg, October 7

Our checks indicate that sales are now falling to direct sales key accounts.

Doors Closing

Kone outperformed the market in China in H1. Our research indicates that Kone sales will turn down 7% in H2 2015. The regions that had sustained Kone's growth, South and East China fell around 5% in Q3 after being slightly up or flat in H1 2015. Other regions continued to show around 10% declines.

Table 1. Kone Sales Estimates

Kone Sales		H1 15	H2 15	2015
Kone Brand Direct Sales	42%	7%	-4%	2%
Kone Brand Distributor Sales	28%	0%	-8%	-4%
Giant Kone Distributor Sales	30%	-8%	-10%	-9%
Total	100%	0.50%	-6.90%	-3%

Source: J Capital

Kone's sales strength is built on direct sales to large, listed property developers, who comprise 60% of the Kone brand elevator sales. Probably because of superior access to capital, those developers have dramatically outperformed the market in their housing completions, but they now project growth to flatten by the end of the year and go negative in 2016. Given the sales cycle of elevators, six months before completion, this indicates the end of Kone's growth phase. In fact, our checks indicate that sales are now falling to direct sales key accounts.

We identified six of the company's direct-sales clients, and they account for around 5% of all residential completions in China. From the 2015 Interim reports of these listed companies we can see that weighted average completions growth was around 33%. These companies indicate that completions will continue at this pace till year-end before growth goes flat and trends down in 2016. As sales are six months before completions, it is clear that strong sales growth provided by this client group will have peaked in H1 2015.

Table 2. Direct Sales Clients of Kone

Developer	Ticker	SQM (mil) Completed	H1 15 Completions	H1 15 New Construction
Vanke	2202	5.2	30%	5.20%
Wanda	3699	4.4	17%	13%*
Longfor	960	3.6	27%	9%

China Resources	1109	0.6	120%	-10%
China City South	1668	3.3	51%	20%
Greenland	337	0.09	-10%	

Source: Company Reports, J Capital

Kone sells to infrastructure projects and smaller developers via distributors. Infrastructure sales remain steady, however, smaller developers are hardest hit and sales declines to this segment are the greatest. Nearly all of Giant-Kone sales are made via distributors that sell to smaller developers including social housing projects. This is the weakest segment of the market and has been declining all year.

Table 3. J Capital Q3 Survey of Elevator Sales

Location	Q3 Elevator Market Sales	Q3 Kone Orders	Q3 Kone Sales	Kone Price	Maintenance	Delays	Notes
Guangzhou, Guangdong (South)	-10%	Flat	-5%	-5% (2014 -2%)	Growing and stable margins	Increase by 2 months	Kone direct and distributor sales both down, direct sales down less.
Shenzhen/ Zhuhai (South)	-10-15%	0%	0%	-5%	Cost rising due to safety concerns Growing at 18%.	Orders now placed 3 months before installation	Direct sales grew at 20% in 2014 now falling. Otis prices down 15% from 2 years ago.
Wuxi, Jiangsu (East)	-5-10%	-5%	0%	-4%	Growing at 15-20%	Delays increasing	Kone orders from nearby cities 70% Sales are direct and are better than distributors
Lishui, Zhejiang (East)	-20%		-10%				Almost no new property projects
Shandong (North)	-10%		-10%				Kone 30% of sales to distributors (sales were worse in 1H down 20-30%)
Sichuan (West)			10%			Delays increased	Sales down 20-30% YTD
Zhengzhou, Henan (Central)	-30%	5%	-10%			Delays increease	50% direct sales, AR delays, Replacement market small

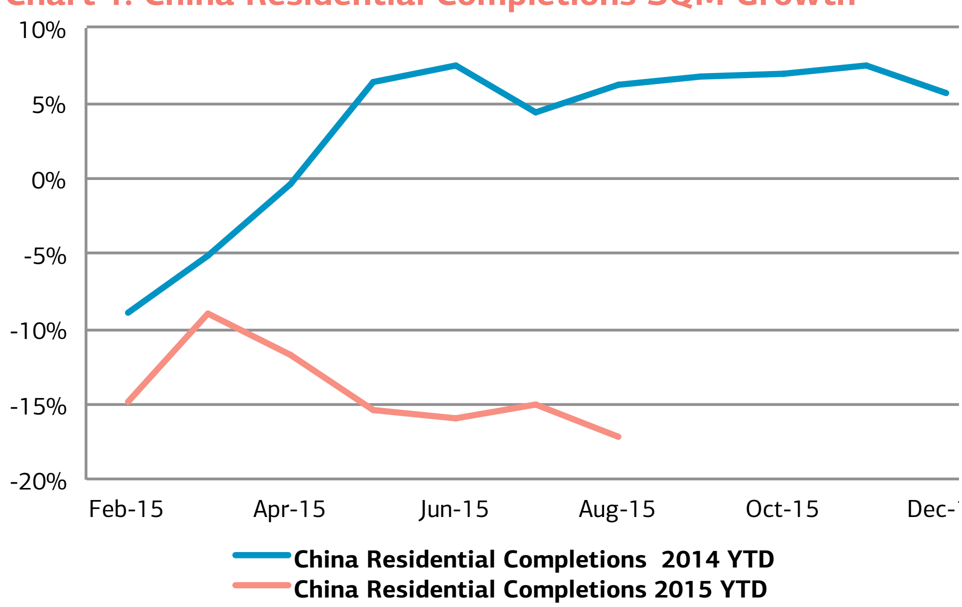
Source: J Capital, 14 interviews, in person and telephone, September 2015

The Market: Bad All Year

The residential property completions growth that sustained elevator sales in 2014 has been reversed in 2015. Residential property development is 60% of elevator demand and has been the key driver of elevator sales growth. The two provinces of Zhejiang and Guangdong, which accounted for 78% of the completions growth in 2014, are now down 38% and 45% YTD August respectively. Recently attention has been focused on improved real estate transactions in Tier 1 Cities, but we have not seen this translate into improved construction. Completions in Beijing and Shanghai have slowed from growth of 27% and 58% respectively YTD March to -2% and 3% YTD August. Importantly, total completions in key provinces like Zhejiang are greater than Beijing and Shanghai's combined, and Guangdong's are double these two cities

The direction of elevator sales is clearly down. Not only are new starts in residential property construction down 18% YTD August and 30% compared with the peak in December 2013, but inventory in the top 14 cities remains very high, and land sales for residential development are down 51%. We can expect the decline in completions that started this year to pick up pace next year as the slowing new construction impacts completions.

Chart 1. China Residential Completions SQM Growth

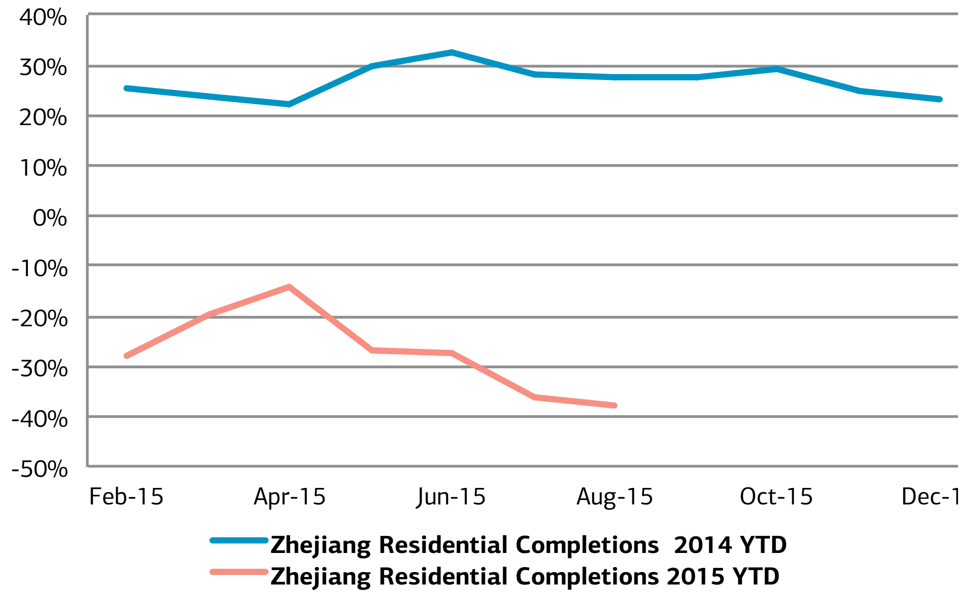


Source: NBS, J Capital

Maintenance: No Growth Solution

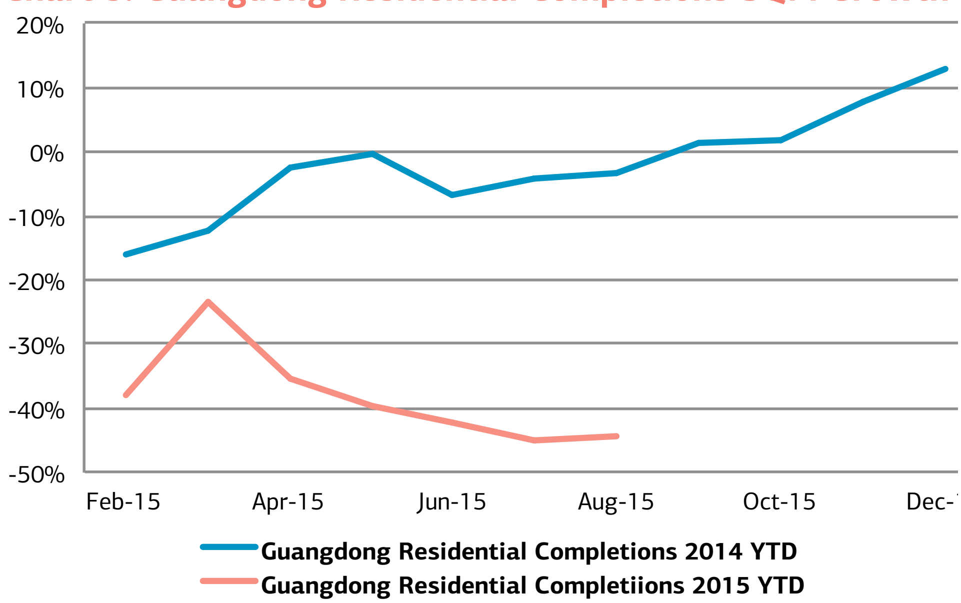
Kone is working to grow its maintenance business. For the Kone brand, that growth is around 15% and margins are stable. Price competition and

Chart 2. Zhejiang Residential Completions SQM Growth



Source: NBS, J Capital

Chart 3. Guangdong Residential Completions SQM Growth



Source: NBS, J Capital

high labor costs will continue to ensure that this business is less attractive than new equipment. Giant-Kone is totally reliant on distributor sales, and maintenance margins in that segment are zero. This limits Kone's ability to grow maintenance conversion much beyond current rates.

We believe Kone will achieve its stated target of maintenance making up

10% of China revenue. On the recent capital markets day we found senior management less enthusiastic about the prospects of this category of revenue.

Replacement Market: No Growth Solution

Much has been made of the potential of the replacement market as new development falls. We see this remaining a very small niche segment of the market at less than 2% of sales. Chinese regulations are vague on the time period for enforced renewal. Various people we interviewed gave ranges from 10-20 years of service before replacement. Property owners and distributors point out that elevators are the responsibility of the management company normally controlled by the owners. They are reluctant to spend on expensive brands when replacement is required.

Valuation: DCF PT Euro 25.93 Downside of 30%

We raise our price target from 25.70 to 25.93 as our decline in China sales is changed from down 10% to down 3% in 2015.