

格力电器 [000651.CH]

国内空调行业的标杆企业

格力电器是中国领先的空调制造商，国内市场份额约 40%。由于公司拥有强大的品牌、良好的客户忠诚度和较高质量，其产品价格有明显的溢价。格力受益于近期国内对空调的强劲需求；然而，由于公司的产品和目标市场均较单一，且缺乏清晰的盈利增长驱动力，再加上未有连贯的增长策略，意味着公司估值将继续较同业折让。

投资亮点

空调：竞争激化。空调占格力销售额的 80% 以上，另占毛利的 90%。预计今年的空调需求将保持强劲，料第一季空调销售额同比增长 33%，而 4 月/5 月的安装量将加快增长。虽然格力的空调产品存在溢价，但其他制造商正在推出更多高端型号，或会侵占格力的市场份额。

多元化策略未取得重大成功。格力试图多元化其业务，并开拓智能手机、电动公交车和小家电业务，并且开发出口市场，但未见取得重大成功。这意味着公司仍是单一产品和单一市场的公司。

公司未有连贯的政策。在格力宣布暂停派发 2017 年股息以保留资金作智能制造、集成电路等新领域的拓展后，其股价一度暴跌。虽然格力可能会在中期业绩后恢复派息，但市场仍对格力摇摆不定的政策感到忧虑。由于董明珠可能继续连任主席三年，我们预计管理层的风格不会有任何变化。

充裕的现金状况提供防御性。格力的现金净额为 850 亿元人民币（占市值的 32%）。我们预计部分现金流将在未来 18 个月予以分派，形式将是股票回购或提高股息。此外，公司还持有约 7 亿美元的外汇，因此公司或受益于人民币贬值。

从近期盈利增长前景看，目前估值合理。格力有望在 2018 年上半年实现稳健的盈利增长，其低估值或导致股价在大盘疲弱时跑赢预期。然而，鉴于格力的业务有高度的周期性，并依赖于单一产品类别，加上增长策略缺乏明确性，我们认为格力会较海尔和美的等同业存在折让。我们给予公司的 2019 年目标市盈率为 9.5 倍，12 个月目标价为 48 元人民币，潜在上升空间约 11%。

	2016	2017	2018E	2019E	2020E
收入(百万人民币)	110,113	150,020	178,252	203,787	223,364
增长 (%)	9%	36%	19%	14%	10%
净利润(百万人民币)	15,464	22,402	26,212	30,409	33,601
增长 (%)	23%	45%	17%	16%	10%
每股盈利(人民币)	2.57	3.72	4.36	5.05	5.59
市盈率 (倍)	16.8	11.6	9.9	8.5	7.7
市净率 (倍)	4.8	4.0	3.2	2.7	2.2

来源: 公司年报, 中国银河国际证券研究部

家电行业

持有

(首次覆盖)

收盘价: 43.18 元人民币 (2018年7月4日)

目标价: 48 元人民币 (+11%)

股价表现



市值	391.71 亿美元
流通在外股数	60.16 亿股
自由流通量	56%
52 周高位	58.7 元人民币
52 周低位	36.4 元人民币
三个月日均成交额:	4.17 亿美元
主要股东:	格力集团 (18.2%)

来源: 公司, 彭博

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GREE ELECTRIC [000651.CH]

Queen of AC'es

Gree is the leading air con manufacturer in China, with a domestic market share of ~40%. Its products command a definitive price premium due to Gree's strong brand, customer loyalty, and quality. Gree is benefitting from recent strong domestic demand for air conditioning; however, its single-product single-market focus, lack of new discernible earnings drivers, and inconsistent growth strategy mean the Company will continue trading at a valuation discount to its peers.

Investment Highlights

Air Conditioning: Encroaching Competition. Air conditioners account for over 80% of Gree's sales and 90% of its gross profit. AC demand is expected to remain strong this year, with AC sales increasing 33% YoY in Q1 and installations accelerating in April/May. While Gree's AC products sell at a premium, other manufacturers are introducing more high-end models which may encroach on Gree's turf.

Limited Success in Diversification. Gree's attempts to diversify into smartphones, electric buses and small appliances and to develop export markets have been met with limited success. This means the Company remains a single-product single-market company.

Inconsistent Corporate Policy. Gree's share price plummeted when it announced it would suspend its 2017 dividend to diversify into new fields such as smart manufacturing, integrated circuits, and others. While Gree will likely resume dividend payments following interim results, the market remains concerned over Gree's wavering policy. With Dong Mingzhu likely to serve as Chairwoman for another three years, we do not expect any changes in management style.

Defensive Cash Position. Gree has a net cash position of RMB85Bn (32% of its market cap). We expect some of this cash pile to be distributed, either through share buybacks or in bumper dividends over the next ~18 months. In addition, the Company also holds around ~USD 7Bn in forex, and may benefit from RMB depreciation.

Fair Valuation in Light of Near-term Earnings Growth. Gree is tracking for solid earnings growth in 2018H1, and its low valuation may result in outperformance in a stock market downturn. However, in light of Gree's highly cyclical business, reliance on a single product category, and lack of clarity on growth strategy, we believe Gree warrants a discount relative to peers Haier and Midea. We value the company on 9.5x 2019E earnings, implying a 12-month target price of RMB 48, or ~11% upside.

	2016	2017	2018E	2019E	2020E
Revenue (RMB Mn)	110,113	150,020	178,252	203,787	223,364
Growth (%)	9%	36%	19%	14%	10%
Net Profit (RMB Mn)	15,464	22,402	26,212	30,409	33,601
Growth (%)	23%	45%	17%	16%	10%
EPS (RMB)	2.57	3.72	4.36	5.05	5.59
PER (x)	16.8	11.6	9.9	8.5	7.7
PBR (x)	4.8	4.0	3.2	2.7	2.2

Sources: Company Annual Report, CGIS Research

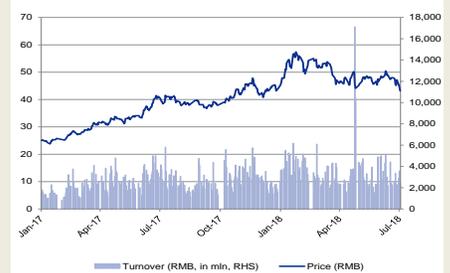
Home Appliances Sector

Neutral
(Initiation)

Close: RMB 43.18 (July 4, 2018)

Target Price: RMB 48 (+11%)

Share Price Performance



Market Cap	US\$39,171m
Shares Outstanding	6,016m
Free Float	56%
52W High	RMB 58.7
52W Low	RMB 36.4
3M Avg Daily T/O:	US\$ 417m
Major Shareholders:	Gree Group (18.2%)

Sources: Company, Bloomberg

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VALUATION

We have a target price of RMB 47.98, based on a 9.5x multiple of our 2019 earnings forecast. This valuation is supported by Gree's 14%+ earnings CAGR during 2017-2019 and its 30%+ ROE.

Midea and Qingdao Haier, two of the three large appliance manufacturers, both trade for ~12x 2019E consensus earnings. Midea and Haier both have diverse product portfolios. Gree is a pure play on air conditioning, and currently trades at a discount to Midea and Haier at 8.5x our forecasted 2019 earnings.

Figure 1: Peer Comparison

	Ticker	Mkt Cap USD Bn	Price (LC)	PE Ratio			EPS Growth		PEG	PB	EV/EBITDA			Yield	ROE
				2017	2018E	2019E	2018E	2019E			2017	2018E	2019E		
A share															
Gree*	000651 CH	39.2	43.18	11.6	9.9	8.5	17.0%	16.0%	0.6	4.0	6.3	5.5	4.8	0.0%	34.2%
Midea*	000333 CH	45.1	45.11	17.1	13.7	10.8	24.8%	26.9%	0.6	4.0	11.7	9.7	8.0	2.7%	23.4%
Qingdao Haier	600690 CH	16.7	18.18	16.0	13.9	12.0	15.2%	15.8%	0.9	3.4	11.8	9.7	8.4	1.9%	21.5%
Robam	002508 CH	4.0	28.30	17.8	15.2	12.3	17.6%	23.0%	0.9	5.0	14.3	12.0	10.0	1.9%	27.8%
Supor	002032 CH	6.2	50.14	31.3	25.6	21.3	22.2%	20.5%	1.2	7.9	23.8	20.0	16.8	1.4%	25.3%
Little Swan	000418 CH	5.1	60.24	25.3	20.4	16.8	23.8%	22.0%	0.9	5.4	22.5	15.8	13.0	1.7%	21.4%
Median				17.4	14.5	12.2	20.1%	20.2%	0.9	4.5	13.8	11.3	9.6	1.8%	24.4%
H share															
Haier Electronics	1169 HK	8.7	24.35	17.3	14.3	12.1	21.1%	17.7%	0.7	2.8	9.9	8.1	6.9	0.8%	16.1%
International															
Whirlpool	WHR US	10.3	146.15	30.6	9.4	8.3	226.9%	13.1%	0.0	2.5	7.7	7.2	6.9	2.9%	8.1%
Electrolux	ELUXB SS	6.8	193.40	9.7	10.9	9.5	-11.0%	14.8%	-1.0	2.7	5.4	5.6	5.0	3.9%	27.9%
Rinnai	5947 JP	4.5	9,580	22.3	21.8	21.4	2.3%	2.0%	9.4	1.8	8.3	8.3	7.8	0.9%	8.2%
SEB	SK FP	8.6	148.10	19.6	17.1	15.2	14.5%	12.6%	1.2	4.2	11.8	10.9	10.0	1.4%	21.2%
De'Longhi	DLG IM	4.2	24.06	20.2	19.4	17.7	4.5%	9.7%	4.3	3.5	10.9	10.2	9.5	4.2%	17.4%
Daikin Industries	6367 JT	34.1	12,855	24.4	20.9	19.8	16.7%	5.4%	1.2	3.4	13.1	12.0	11.2	1.0%	13.8%
Median				21.3	18.2	16.4	9.5%	11.1%	1.2	3.0	9.6	9.2	8.7	2.1%	15.6%

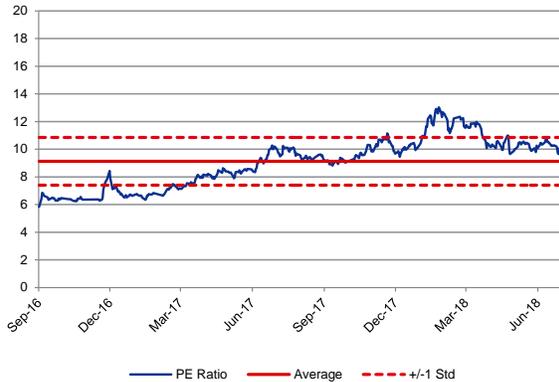
Sources: Bloomberg, CGIS Research

Note: * Gree figures based on CGIS forecast

While Gree's earnings growth can remain strong in 2018 due to hot weather and strong AC demand, this period of above trend earnings growth may not sustain beyond 2018. We prefer manufacturers with a more reliable and diversified earnings stream whose EPS growth is higher than Gree.

We value Gree at a discount to Haier and Midea on account of the volatile nature of its core air conditioning business, its recent dividend cut, and current overhang on the stock due to potential change in leadership. At 9x 2019E PER, Gree's valuation would be lower than domestic peers but in line with the international appliance manufacturers such as Electrolux and Whirlpool. Gree has historically traded at a discount to its domestic peers Midea and Qingdao Haier.

Gree PE Band



Sources: Bloomberg, CGIS Research

Midea PE Band



Sources: Bloomberg, CGIS Research

Qingdao Haier PE Band



Sources: Bloomberg, CGIS Research

Of the three major A-Share listed appliance manufacturers, Gree appears less favoured by investors utilizing the northbound stock connect than Midea. Northbound connect owners own 7.8% of Gree, versus 11.6% of Midea and 7.9% of Qingdao Haier. However, since MSCI inclusion on June 1, 2018, investors utilizing the Hong Kong stock connect have invested a net RMB 2Bn in Gree, closely following the net RMB 3.6Bn invested in Midea.

Figure 2: Foreign Investment in Gree

% Ownership by Northbound Stock Connect				Northbound Net Buying from June 1, 2018			
Ownership(%)	12-Jun-2017	30-Dec-2017	4-Jul-2018	Shares (Mn)	31-May-2017	4-Jul-2018	Net Buying (RMB Mn)
Gree	5.1%	8.4%	7.7%	Gree	426.4	465.0	1,833
Midea	5.0%	9.6%	11.6%	Midea	701.6	767.6	3,515
QD Haier	7.3%	8.8%	7.9%	QD Haier	499.8	484.5	-304

Sources: HKEX, CGIS Research

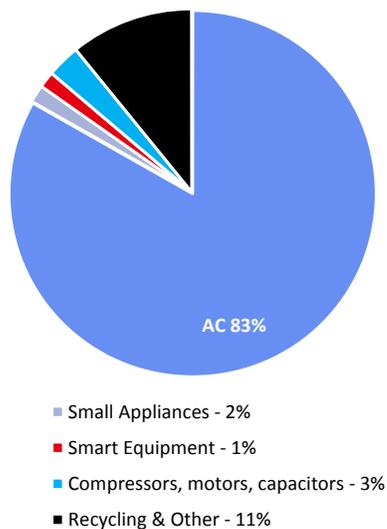
OVERVIEW: AIR CONDITIONING TO DRIVE EARNINGS

Air Conditioning (83% sales)

Gree's focus on air conditioning differentiates it from chief competitors Gree and Haier. Air conditioning accounts for 83% of revenue and 94% of gross profit. Gree has long tried to diversify into other market segments, but still relies on AC as its main profit driver.

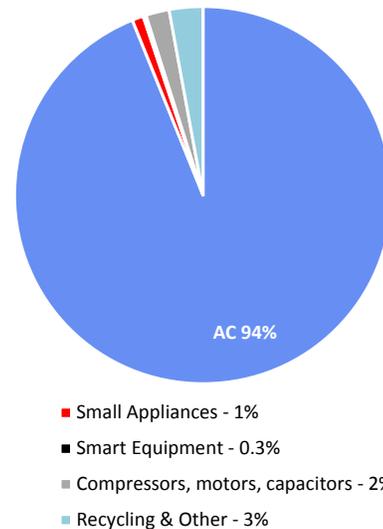
Gree has been the leading producer of air conditioners in China since 1995 and in the world since 2005. Gree's domestic market share is consistently above 40% by volume. Gree also enjoys extremely high brand recognition and a premium price position in the market. The company has a capacity of over 60 million residential AC sets, and over 5.5 million central AC sets. Most of these are sold in China

Figure 3: Revenue Mix (2017)



Sources: Company Annual Report, CGIS Research

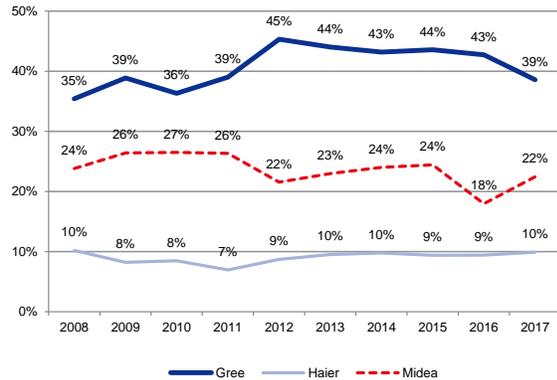
Figure 4: Gross Profit Mix (2017)



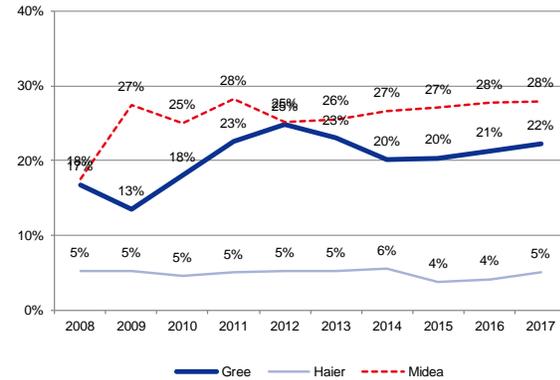
Sources: Company Annual Report, CGIS Research

China's AC Market Overview

The air conditioning segment is Gree's most important product category, representing over 90% of gross profit. Domestically, the AC market is dominated by three players Gree, Midea, and Haier, which control roughly ~70% of the market. Gree is the leading player in China's domestic AC market.

Figure 5: AC Market Share by Volume (Domestic vs. Export)
Domestic Market Share


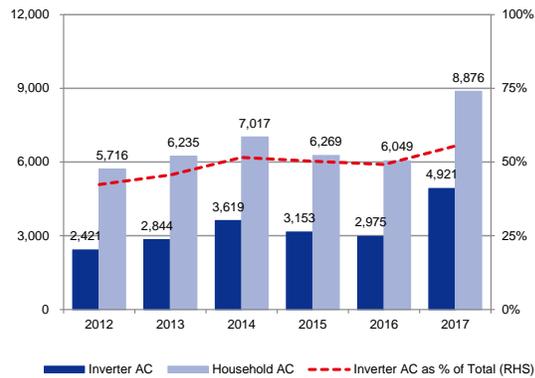
Sources: Wind, CGIS Research

Export Market Share


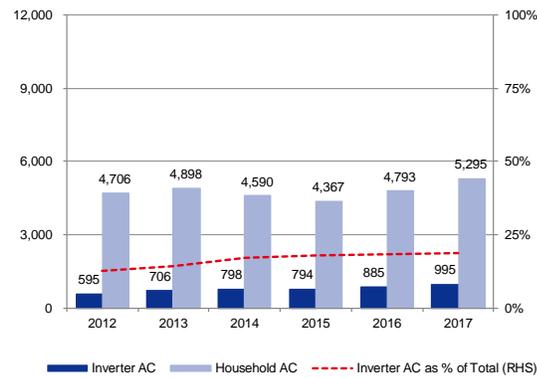
Sources: Wind, CGIS Research

2018H1: AC Growth Still Strong

2017 was a boom year for China's AC market due to hot weather, low channel inventory, and a recovering property market following 2015 lows. In volume terms, China's domestic AC market grew 47% YoY to ~89Mn units. In the export market, AC sales grew ~10% to ~53Mn units.

Figure 8: China AC Volumes (Domestic vs. Export)
Domestic (10,000 units)


Sources: Wind, CGIS Research

Export (10,000 units)


Wind: Company Annual Report, CGIS Research

As of 2018Q1, the air conditioning market in China is continuing to experience strong growth:

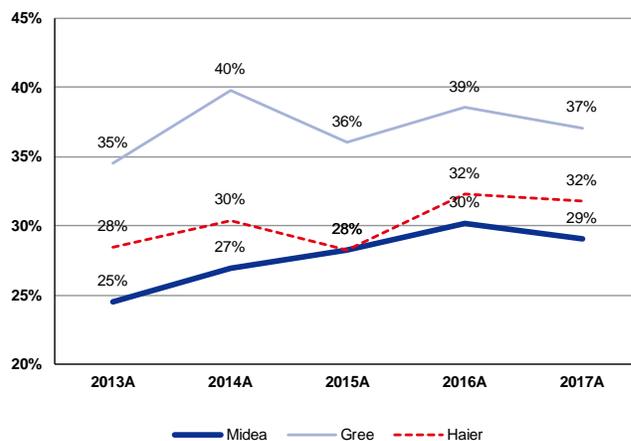
- Gree grew top line revenues 37% in 2018Q1. Gree has seen an acceleration in installations in April and May over Q1, with installation growth tracking 20% YoY
- Midea's air conditioning business grew +40% YoY in 2018Q1. In April, Midea's AC growth decelerated to 20% YoY.
- Haier AC revenue grew ~20% YoY in 2018Q1, with growth accelerating in April and May and installations tracking

For full year 2018, we expect Gree's AC segment to grow ~20% YoY. Our estimates are more conservative than management guidance, which place sales growth for 2018 at 33%.

Gree's Industry Leading AC Margins

As a result of its high ASPs and product mix, Gree's gross margins lead its peers in the AC segment. In our checks with Gome, Suning, and multi-brand department stores, we learned that Gree typically charges a premium of RMB ~200-300 over Midea and Haier for similarly configured AC units. Gree has a reputation in the market place for excellence in manufacturing durable compressors, which remain quiet and energy efficient over their lifespan.

Figure 10: AC Gross Margin by Manufacturer



Sources: Company Annual Report, CGIS Research

In addition to higher ASPs among units with similar specifications, our online checks show that Gree's product mix is skewed toward higher ASP models. For example, Gree's top selling units online are priced RMB 1,000-1,500 higher than the top sellers for Midea and Haier on TMall, Gome, and Suning's online stores:

Figure 9: Top Selling Online AC Models by Brand (as of May, 2018)

Tmall			Gome		Suning	
Make	Model (Power)	Price	Model (Power)	Price	Model (Power)	Price
Gree	Fengcai 35GW (inverter)	*3,449	Comfort Style 26GW (inverter)	4,199	Trait Ideal 35GW	3,399
Midea	iQingchun 26GW	*2,099	Zhihu 35GW	2,349	Zhihu 35GW	2,399
Haier	Le+ 32GW	*2,199	Zhi+ 35GW	2,399	Zhi+ 35GW	*2,799

Note: * Under promotion

Source: TMall, Gome, Suning, CGIS Research

AC: Encroaching Competition

In the past, Gree has focused more on high-end models, which have helped the company earn leading margins. Other manufacturers, however, are introducing more high-end models, which may weaken Gree's current position.

Haier, for example, has been enjoying success with new high end AC models. In 2017, Haier introduced new air purification series *Casarte Yunding* and *Tianxi*. According to CMM data, Haier increased its market share in the RMB 4,100+ price segment by 6.8 percentage points, reaching 10.5% in 2017. For residential AC units priced above RMB 8,000, Haier increased its market share from 12.4% to 22.9%.

Furthermore, according to Euromonitor data, Haier leads globally in smart air conditioning systems with a 30.5% market share.

While Midea is best known for its mid-tier ASP products, the company is taking steps to move up market. Midea is introducing a new premium brand, which should roll out in August/September 2018. The products will be priced at or above Haier's existing high-end products, *Casarte*. In general, Midea is specifically attempting to narrow its pricing gap with Gree in the air conditioning segment. While historically, Midea has lagged Gree in pricing by 700-800 in ASP for a comparable model, Midea has narrowing this gap by introducing new models which typically sell at a discount to Gree by 300-400 RMB. This will put pricing pressure on Gree's product offering, in our opinion.

LIMITED SUCCESS IN DIVERSIFICATION

Gree is still singularly reliant on air conditioners. Despite the Company's efforts to diversify its product range, the other products account for only 17% of revenues and 6% of gross profit. The Company's international sales were only RMB 18.5Bn (or 12% of revenue), which is small compared to Midea's RMB 104Bn.

Other Product Offering

Gree controls two brands including *GREE* and *TOSOT* for its products. The *GREE* brand is reserved for the company's air conditioning, other large appliance (i.e. water heater, washing machine), smartphone, and industrial products. *TOSOT* is reserved for Gree's small appliances business.

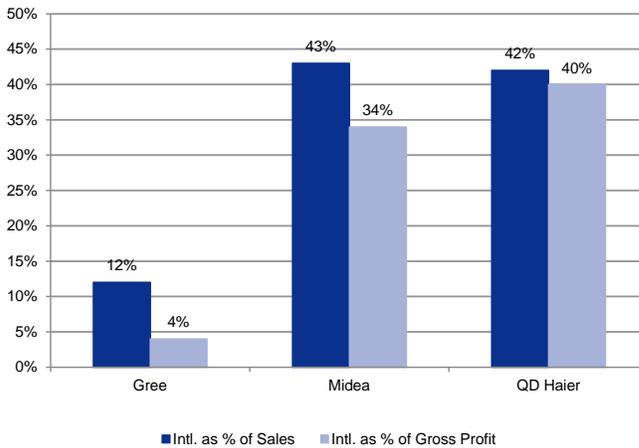
Gree's existing businesses outside of the company's AC segment have yet to make a meaningful contribution to company earnings.

- **Other (11% Sales, 3% of Gross Profit):** Gree's second largest source of revenue comes from "Other," which includes appliances recycling. Since 2011, Gree has established recycling centres in Shijiazhuang, Zhengzhou, Tianjin, Wuhu, and Changsha. According to a 2013 White Paper, approximately 100 million electronic appliances were discarded annually in China – including televisions, refrigerators, washing machines, and air conditioners. Gross margins in this business segment are low, averaging 7% from 2016-17.
- **Compressors, motors, capacitors (3% Sales, 2% of Gross Profit):** Gree is vertically integrated in compressors, motors, and capacitors, and sells a limited amount of production to external customers.
- **Small Appliances (2% Sales, 1% of Gross Profit):** Gree has attempted to gain traction in the small appliances market with its *TOSOT* brand, which manufactures fans, pressure cookers, water purifiers, air purifiers, induction cookers, dehumidifiers, and other kitchen appliances. Although Gree's small appliance business is growing, it has yet to make a significant impact on the company's financial accounts, comprising ~2% of sales. In 2010, Gree's small appliance sales were RMB 787Mn, versus 2.3Bn in 2017. Over the same period, Gree's air conditioning business grew from RMB 55Bn to 123Bn.
- **Smart Equipment (1% sales, <1% of Gross Profit):** In 2017, Gree introduced a new reporting segment called smart equipment (~1% sales). Gree's first smart equipment product, however, an AGV, was introduced in 2013. To date, smart equipment is still a small portion of Gree's overall sales mix. The segment currently manufactures industrial robots, CNC machines, and AGVs. Gree's aim is to transition its own manufacturing process toward smart precision manufacturing.

Revenue Dependency on China

Gree derives only 12% of its revenue and 4% of its gross profit internationally, lower than that of Midea and Haier. While China has recently been experiencing strong demand for AC this year, Gree's reliance on a single market makes the company's earnings inherently more volatile than its peers.

Figure 6: International Sales Contribution by Manufacturer



Source: Annual Reports, CGIS Research

Gree's key international markets include the Middle East, as well as Brazil and Pakistan where Gree has manufacturing plants. Around 60% of Gree's international appliance sales are from low margin OEM and ODM products. Hence, Gree's gross margins are significantly higher in Mainland China, where all sales are under its own brands, than in the international market.

Figure 7: Gree's Appliance Gross Margins by Region

Gross Margin (%)	2013	2014	2015	2016	2017
Mainland China	38%	42%	38%	41%	40%
International	12%	20%	17%	17%	11%

Source: Annual Reports, CGIS Research

Past efforts at Diversification

Under the leadership of Dong Mingzhu, Gree has made several attempts at diversifying into new business segments to drive growth. Gree appears to be targeting high growth businesses which appear to have only limited synergies with its core AC business.

- Failed Yinlong Acquisition:** On March 5, 2016, Gree proposed to acquire 100% of Yinlong New Energy by issuing 1.5Bn shares at 15.57 per share (worth RMB 13Bn), and planned to raise not more than RMB 9.7Bn by issuing non-public supporting funds. However, based on Gree's balance sheet at the time, Gree had ~80Bn in net cash, seemingly more than sufficient to acquire Yinlong without issuing new shares. The deal was ultimately vetoed by Gree's shareholders. However, the acquisition attempt resulted in the suspension of Gree's shares for nearly seven months beginning from February 22, 2016. Shares resumed trading in September that year.

Dong Mingzhu was a proponent of Yinlong's technology in energy storage equipment (Lithium-ion battery). After the failed acquisition attempt of Yinlong, Dong Mingzhu personally invested into Yinlong and became the second largest shareholder in April 2017 with 17.5% stake (worth ~RMB 200Mn). In comparison, her shareholding in Gree as of today is 0.7% (worth ~RMB 2Bn).

- 2. Struggling Smartphone Business:** Gree entered the smartphone business in 2015 and so far has released 2 generations of Gree phones. The first generation of Gree phones was launched in early 2015, and a second in June 2016. Sales proved disappointing. As of April 2018, the Gree's second generation phone has sold less than 100,000 units. A 3rd generation of Gree phone is expected to come to the market in second half 2018. In our view, the smartphone manufacturing business shares few synergies with Gree's core AC business. We suspect it will be difficult for Gree to compete with large scale competitors in the smartphone market such as Vivo, Oppo, and Xiaomi.

NO APPARENT UPSIDE IN CORPORATE STRATEGY

Wavering Dividend Policy

Gree has been considered a dividend play by the market on account of its lower PER and high payout ratio, leading to an indicative dividend yield of 5%+. In April 2018, Gree declared zero dividend for 2017 results, on grounds that it would preserve the cash for potential capacity expansion, as well as M&A in areas including smart manufacturing, integrated circuits, and others. This was a negative surprise to investors, given the Company's cash balance and past practices. The resulting sell-off erased RMB 30Bn from the company's market cap that day. The Shenzhen Stock Exchange sent a letter of concern to Gree over the sudden change in policy.

Gree had historically paid out ~70% of its net income in dividends to investors in the preceding two years. Since Gree's initial announcement, the company has remedied its position on the dividend cut, and is now indicating that an interim payment will be made following interim results.

Lack of Clear Growth Direction

Following Gree's June 25 2018 AGM, the company has not yet provided specifics to investors regarding the company's longer term growth strategy and where it plans to invest cash. Gree has discussed potential investment in semiconductor design, smart manufacturing equipment, communications equipment, and smart factories all as potential uses of cash. Most recently, we have seen news reports that Gree plans to invest ~RMB 4Bn per year in semiconductor design, but details remain scarce. Reportedly, a portion of Gree's air conditioners already use chips based on Gree's in-house design, and Gree will continue to expand its design capability long term.

No Catalysts for Change

Chairwoman Dong Mingzhu has been serving as Chairwoman of Gree Electric since 2012. As of May 31, 2018, her 3rd consecutive term was up for re-election. The May 31st deadline passed with no news, until Gree announced on June 6, 2018 that Dong Mingzhu's re-election would be postponed to the annual shareholders meeting on June 25, 2018. With Dong Mingzhu likely to remain at the helm at Gree, it is probable that erratic strategic moves by the Company will continue to frustrate investors. In the past 24 months, Gree has:

- 1.) Broken its 11 year track record of paying continuous dividends, while failing to inform shareholders where funds will be spent;
- 2.) Entered the highly competitive smartphone business and failed to achieve critical scale; and
- 3.) Attempted to acquire Yinlong, an electric bus company by diluting shareholders, in spite of Gree holding ample cash on the balance sheet. The Yinlong acquisition resulted in Gree's shares being suspended for approximately seven months.

DEFENSIVE CASH POSITION

One factor which is positive of Gree is its huge cash balance of RMB 105Bn and relative low debt level of RMB 20Bn at the end of 2018Q1. This implies the Company has net cash of RMB 85Bn, which is equivalent to 32% of its market cap. Although most home appliance manufacturers enjoy a strong financial position, Gree's cash position is significantly higher than that of its peers. We believe this has sustained Gree's recent share price performance, by enabling the Company to: (i) make acquisitions at current low valuation to sustain earnings growth, (ii) maintain a high dividend payout ratio, (iii) purchase some of the outstanding shares to bolster EPS and share price, and (iv) book forex translation gains.

Figure 12: Gree's Recent Share Performance

Name	WTD	MTD	YTD
Gree	-5.0%	-9.1%	-4.4%
Midea	-10.6%	-14.7%	-20.0%
QD Haier	-3.9%	-9.6%	-4.3%

Sources: Annual Reports, CGIS Research

Strong Cash Position

Gree enjoys the strongest net cash position among peers, which makes the company a defensive stock and provides Gree with ample dry powder to grow earnings via acquisition.

Figure 11: Gree's Net Cash Position Relative to Peers (Q1 2018)

RMB Bn	Gree	Midea	QD Haier
Cash & Equivalents	105.2	55.4	34.1
Short-term debt	20.2	1.5	13.4
Long-term debt	0.0	37.1	19.6
Net Cash	85.0	16.8	1.0
Mkt Cap	268	316	112
Net Cash / Mkt Cap	31.7%	5.3%	0.9%

Sources: Annual Reports, CGIS Research

Bumper Dividends

Although Gree suspended its dividend in 2018Q1, we anticipate the company will resume paying dividends after 2018 interim results. Management has communicated to the market that the interim dividend is a delayed payment on 2017 earnings. Hence we estimate the 2018 interim payout will be approximately RMB 1.86 per share, or ~50% of 2017 earnings, and further assume that Gree will continue to maintain a 50% payout ratio for 2018 and beyond. On this basis, we anticipate strong dividends over the next ~18 months. While this interim dividend is a one-off exception, this still represents a nice 10% payoff to investors.

Figure 13: Gree's Dividend History

	2013	2014	2015	2016	2017	2018E	2019E	2020E
Interim DPS	0.00	0.00	0.00	0.00	0.00	1.86	0.00	0.00
Annual DPS	0.75	1.50	1.50	1.80	0.00	2.18	2.53	2.79
Total DPS	0.75	1.50	1.50	1.80	0.00	4.04	2.53	2.79
EPS	1.81	2.35	2.08	2.57	3.72	4.36	5.05	5.59
Payout Ratio	42%	64%	72%	70%	0%	93%	50%	50%

Sources: Annual Reports, CGIS Research

USD Holdings to Result in Forex Gains

As of 2017 year end, Gree held USD ~6.9Bn in cash & equivalents against USD ~1.5Bn in debt, giving the company ~USD 5.5Bn net exposure. Recent RMB depreciation may result in a forex gain in 2018. When the RMB last depreciated from 6.4936 to 6.937 in 2016, or 6.4%, Gree booked an exchange gain of RMB 3.7Bn. Year to date, the RMB has depreciated approximately 2.4%.

Figure 14: Gree's USD Currency Position

in USD Mn	2013	2014	2015	2016	2017
USD Cash & Equivalents (USD Mn)	2,972	2,629	2,659	6,033	6,964
USD Denominated Debt (USD Mn)	174	922	967	1,518	1,551
in RMB Mn					
USD Cash & Equivalents (RMB Mn)	18,121	16,086	17,267	41,852	45,507
Gree Total Cash & Equivalents (RMB Mn)	38,542	54,546	88,820	95,754	99,610
% Cash & Equivalents held in USD	47%	29%	19%	44%	46%

Sources: Annual Reports, CGIS Research

RISK FACTORS

Earnings Volatility

The air conditioning business in China is highly volatile due to its dependency on weather, the real estate market, and channel inventory swings. In particular, the investment community has limited insight into distributor inventory levels. Gree's AC segment comprises over 90% of gross profit.

Limited Diversification in Distribution

Relative to Haier and Midea, Gree is reliant on traditional distributor channel for sales. Gree sells ~70% of its air conditioners and small appliances through 27 Tier 1 distributors, which typically divide their geographic coverage by province. These distributors move Gree's appliances to a network of city and county level distributors, and ultimately to a network of 30,000 Gree branded specialty stores. Relative to competitors, Gree is more reliant on this opaque channel for sales.

Figure 15: China Distribution Model by Manufacturer

	Gree	Midea	Haier
Branded Stores	~70% sales: ~30,000 Gree stores, owned by distributors	~ 30% sales	~ 50% sales: Over 35,000 Haier stores, owned by distributors. Distributor inventory monitored by "Yilihuo" APP
Online Sales	~10% sales	~ 30% sales	~ 18% sales
Key Account (Guomei, Suning, Etc)	~10% sales	~ 30% sales	~ 20% sales
Multibrand stores	~10% sales	~ 10% sales	~ 12% sales

Sources: CGIS Research

Tier 1 & 2 City Exposure

Gree's store network is relatively more concentrated in Tier 1 & 2 cities. As such, Gree's sales are influenced by fluctuations in these respective property markets. Local governments in these cities have been implementing tightening measures since 2017H2, and sales transactions are expected to cool throughout 2018.

Dilution and Share Suspension

Gree has made attempts in recent years to diversify outside of its core air conditioning business. On March 5, 2016, Gree proposed an issuance of ~1.5Bln shares to acquire Yinlong. The deal was ultimately vetoed by shareholders, but Gree's shares were suspended for a period of ~7 months (Feb 22 to September 2, 2016) while negotiations dragged on.

Management Transition

Dong Mingzhu has served as Chairwoman since May 2012, but her term is currently up for renewal. Gree has postponed the decision twice since May 31, 2018 without resolution.

Commodity Prices

Raw material prices comprise ~85% of COGS. In years when important commodity prices such as copper and steel rise, management has traditionally implemented ASP hikes. However, management may not always have the ability to completely offset increases in raw material costs.

RMB Appreciation

Gree's balance sheet has substantial USD exposure. As of 2017 year end, Gree held USD ~6.9Bn in cash & equivalents against USD ~1.5Bn in debt, giving the company heavy USD exposure. RMB appreciation would likely result in forex loss.

COMPANY BACKGROUND

History of the Group

Gree Electric Appliances Inc. of Zhuhai is an international air conditioning enterprise which has integrated R&D, manufacturing, marketing and service. Established by Zhu Hongbo in Zhuhai, Guangdong in 1991, Gree started as a nameless factory with 200 employees and annual production of less than 20,000 units. Withstanding the test of time and market, Gree became the domestic home appliance leader in the 2000s under Zhu Hongbo leadership. Started as a regional sales woman at age 36, Dong Mingzhu spent 22 years in Gree through peaks and troughs before becoming Zhu Hongbo's successor in 2012, and has transformed Gree into one of the largest air conditioner manufacturers internationally, recording ~RMB 150Bn revenue in 2017. Gree Electric Appliances went public on the Shenzhen Stock Exchange in 1996.

Gree Electric has developed two core brands, namely *Gree* and *Tosot*. The two brands cover a wide product range including air conditioners, central air conditioning systems, refrigerators, rice cookers, washing machines and other home appliances. Currently, Gree's products are exported to more than 200 countries and regions, and its own brand - *Gree* products, to more than 160 countries and regions.

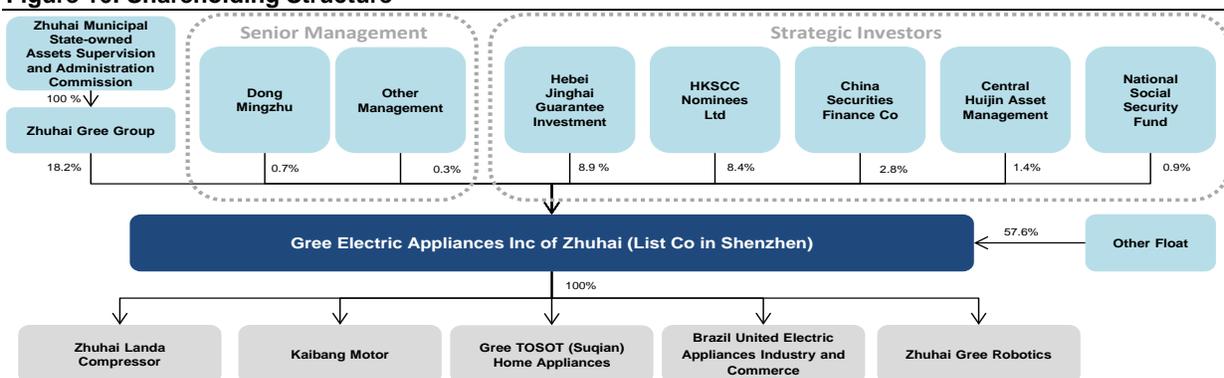
Shareholding Structure

Zhuhai Gree Group, a fully owned entity of Zhuhai Municipal State-owned Assets Supervision and Administration Commission, holds the majority ownership of Gree Electric Appliances with 18.2% of total shares outstanding. Dong Mingzhu, the current Chairwoman of Gree Electric Appliances. Dong Mingzhu holds 0.7% of the Company, with the rest of the board owning 0.3%.

In May 2007, Gree Electric Appliances transferred 10% of equity to Hebei Jinghai Guarantee Investment (later reduced to 8.9% due to new shares issuance and placement), aiming to better incentivize distributors. Hebei Jinghai has since become the second largest shareholder of Gree Electric. Hebei Jinghai is a joint venture of 10 sales companies in Chongqing, Henan, Hebei, Shandong and other regions. In 2007, these 10 sales companies comprised an estimated 65% of Gree Electric's total sales.

Chairwoman Dong Mingzhu has been serving as Chairwoman of Gree Electric since 2012. As of May 31, 2018, her third consecutive term was up for re-election. On June 6, 2018, Gree announced that Dong Mingzhu's re-election would be postponed to the annual shareholders meeting on June 25, 2018. However, following the shareholder meeting, a decision has not still been communicated to the market.

Figure 16: Shareholding Structure



Sources: Company Annual Report, Bloomberg, CGIS Research

FINANCIAL MODEL

P&L Observations:

- 1.) Gree provisions for distributor rebates in selling expenses. These rebates provisions accumulate in "Other current liabilities" on the balance sheet, which reached over RMB 60Bn in Q1 2018. We highlight that selling expenses ranged from 15-20% of sales from 2013-2016 before declining to 11% of sales in 2017. As such, an increase in selling expenses via rebates remains a key risk to our forecast estimates
- 2.) Gree has historically booked RMB 2-3Bn of interest income in the revenue line, which can distort the gross margins of the company in any given year. Ex-interest income, gross margins have ranged between 32-36% in 2013-2017. Raw material costs comprise 85% of COGS. We do not expect aggressive ASP or mix changes in 2018, and have forecasted gross margins at the low end of the company's historical range.

Figure 17: Simplified Consolidated Statement of Profit and Loss

Dec. Year End (RMB Min)	2016	2017	2018E	2019E	2020E
Sales Revenue	110,113	150,020	178,252	203,787	223,364
COGS	(72,886)	(99,563)	(119,521)	(136,428)	(149,592)
Gross profit	37,227	50,457	58,731	67,359	73,772
Sale tax	(1,430)	(1,513)	(1,798)	(2,055)	(2,253)
Selling and distribution costs	(16,477)	(16,660)	(19,796)	(22,631)	(24,805)
General and administrative expenses	(5,486)	(6,071)	(7,214)	(8,247)	(9,039)
Others	(94)	(196)	(196)	(197)	(197)
Total EBIT	13,740	26,016	29,727	34,229	37,478
Depreciation & Amortisation	1,764	2,296	2,362	2,754	3,146
EBITDA	15,504	28,312	32,089	36,982	40,623
Interest expense	(311)	(819)	(1,026)	(751)	(476)
Interest income	1,484	2,205	2,291	2,478	2,727
Exchange gains/ losses	3,702	(1,603)	0	0	0
Others	(43)	819	0	0	0
Pre-Tax Profit	18,573	26,617	30,993	35,956	39,729
Tax Expense	(3,007)	(4,109)	(4,649)	(5,393)	(5,959)
Net Profit After Tax	15,566	22,509	26,344	30,562	33,770
Minority Interest	103	107	132	153	169
Earnings to Equity Owners	15,464	22,402	26,212	30,409	33,601
EPS (Basic)	2.57	3.72	4.36	5.05	5.59
EPS (Diluted)	2.57	3.72	4.36	5.05	5.59
DPS	1.80	0.00	4.04	2.53	2.79
% YoY growth					
Revenue	9.5%	36.2%	18.8%	14.3%	9.6%
Gross profit	7.8%	35.5%	16.4%	14.7%	9.5%
EBIT	9.2%	89.3%	14.3%	15.1%	9.5%
Net profit	23.4%	44.9%	17.0%	16.0%	10.5%
Margins and ratios					
Gross profit margin	33.8%	33.6%	32.9%	33.1%	33.0%
EBITDA Margin	14.1%	18.9%	18.0%	18.1%	18.2%
EBIT Margin	12.5%	17.3%	16.7%	16.8%	16.8%
Net Profit Margin	14.0%	14.9%	14.7%	14.9%	15.0%

Sources: Company Annual Report, CGIS Research

Balance Sheet Observations:

- 1.) Inventory increased steeply in 2017, but the amount remained below three months' worth of sales. This could be the result of year-end effect. From our conversations with management, we understand that Gree's AC factories are currently running at full capacity and are short on inventory
- 2.) Other current liabilities are comprised mostly of accrued sales rebates
- 3.) Other current assets, which increased by RMB 8Bn in 2017, are mostly wealth management and structured products. Without additional information, we assume this to remain stable going forward.

Figure 18: Simplified Consolidated Statement of Financial Position

Dec. Year End (RMB Mln)	2016	2017	2018E	2019E	2020E
Cash & Equivalents	96,005	100,694	108,804	119,645	130,500
Trade and other receivables	34,078	40,213	44,725	50,258	54,881
Inventories	9,025	16,568	16,600	17,432	19,115
Prepayments	1,815	3,718	3,718	3,718	3,718
Other current assets	1,993	10,342	10,342	10,342	10,342
Total current assets	142,915	171,535	184,188	201,396	218,555
Loans and advances	4,737	6,673	6,673	6,673	6,673
PPE, net	18,263	18,488	20,709	22,548	24,004
Intangible assets	3,355	3,604	4,022	4,429	4,827
Deferred tax assets	9,668	10,838	10,838	10,838	10,838
Other non-current assets	3,436	3,829	3,829	3,829	3,829
Total non-current assets	39,459	43,433	46,072	48,318	50,172
Total assets	182,374	214,968	230,260	249,713	268,727
Short-term borrowings	10,701	18,646	13,646	8,646	3,646
Prepayments	10,022	14,143	14,143	14,143	14,143
Notes payable	9,127	9,767	11,288	12,885	14,128
Accounts payable	29,541	34,553	38,180	43,581	47,786
Tax payable	3,126	3,909	3,909	3,909	3,909
Other payables	4,601	5,561	5,561	5,561	5,561
Other current liabilities	59,733	60,912	60,912	60,912	60,912
Total current liabilities	126,852	147,491	147,639	149,637	150,085
Long-term borrowings	0	0	0	0	0
Other long term liabilities	570	642	642	642	642
Total non-current liabilities	570	642	642	642	642
Total liabilities	127,422	148,133	148,282	150,279	150,728
Shareholders Fund	53,972	65,595	80,606	97,910	116,306
Minority Interest	980	1,240	1,372	1,524	1,693
Total S/H Equity	54,952	66,835	81,978	99,434	117,999
Total Liab & S/H Fund	182,374	214,968	230,260	249,713	268,727

Sources: Company Annual Report, CGIS Research

Cash Flow Observations:

- 1.) From 2013 to 2017, Gree paid 42-70% of its net income out as dividends. Although Gree announced it was suspending dividend payment in its 2017 annual results, we expect Gree will resume paying dividend. We assume Gree will pay 50% of net income out as dividends over the next three years, down from Gree's 70% payout ratio for 2016 on account of higher capex spend.
- 2.) In 2017, Gree invested ~RMB 51Bn in fixed term deposits and wealth management products with a maturity of greater than 3 months and it has disclosed these investments in the cash flow statement. We regard these deposits as cash equivalents in our balance sheet, and do not assume any increases in our forecast.
- 3.) In 2017, Gree spent ~RMB 12Bn of cash on investment products. We believe most of this spend went into "Other Current Assets" which is mostly comprised of WMPs and other structured products.
- 4.) Gree has three new appliance factories under construction in Hangzhou, Nanjing, and Luoyang, and is also contemplating acquisitions, both internationally and domestically. We have increased capex figures for 2018 and 2019 for the completion of these factories, but have not built in investment assumptions for any acquisitions.
- 5.) We assume Gree repays some of its short term debt.

Figure 19: Simplified Consolidated Statement of Cash Flows

Dec. Year End (RMB Mln)	2016	2017	2018E	2019E	2020E
Net Income	15,566	22,509	26,344	30,562	33,770
Depreciation & Amortization	1,764	2,296	2,362	2,754	3,146
Change in Working Capital	(906)	(6,883)	605	631	(856)
Other Non Cash Adjustments	(1,565)	(1,564)	0	0	0
Operating Cash Flow	14,860	16,359	29,311	33,947	36,059
Cash recovered from investment	3,441	4,003	0	0	0
Capex	(3,277)	(2,425)	(5,000)	(5,000)	(5,000)
Cash spent on investment *	(1,496)	(12,420)	0	0	0
Investments in Fixed Deposits**	(17,914)	(51,412)	0	0	0
Investing Cashflow	(19,247)	(62,253)	(5,000)	(5,000)	(5,000)
Dividend (ordinary)	(9,180)	(11,121)	(11,201)	(13,106)	(15,205)
Debt Movements	1,328	8,601	(5,000)	(5,000)	(5,000)
Others	2,100	251	0	0	0
Financing Cashflow	(5,752)	(2,269)	(16,201)	(18,106)	(20,205)
Total Cash Flow	(10,138)	(48,164)	8,110	10,841	10,855
Cash Flow Ex. Fixed Deposit Investment	7,776	3,247	8,110	10,841	10,855

Note: * Cash investment in WMPs, primarily booked in "Other Current Assets"

** Cash investment into fixed term deposits, which we regard as cash equivalents

Sources: Company Annual Report, CGIS Research

Figure 20: Summary of Operating Metrics

Dec. Year End (RMB Mln)	2016	2017	2018E	2019E	2020E
Revenue growth					
AC	5%	40%	21%	15%	10%
Small Appliances	13%	34%	20%	15%	15%
Smart Equipment	NA	1220%	20%	15%	15%
Compressors, motors, Capacitors	20%	35%	20%	20%	20%
Recycling & Other	54%	6%	5%	5%	5%
Gross Margin					
AC	38.5%	37.1%	36.0%	36.0%	36.0%
Small Appliances	22.1%	20.7%	21.0%	21.0%	21.0%
Smart Equipment	NA	5.9%	8.0%	8.0%	8.0%
Compressors, motors, Capacitors	0.1%	22.4%	20.0%	20.0%	20.0%
Recycling & Other	6.1%	8.7%	9.0%	9.0%	9.0%
OPEX (as % Revenue)					
Selling Expense	15.0%	11.1%	11.1%	11.1%	11.1%
G&A	5.0%	4.0%	4.0%	4.0%	4.0%
EBIT margin					
	12%	17%	17%	17%	17%
Tax Rate					
	16%	15%	15%	15%	15%
Net profit margin					
	14.0%	14.9%	14.7%	14.9%	15.0%
Days receivables (including bills)					
	83	85	86	85	85
Days payables (including bills)					
	175	150	149	149	149
Days inventories					
	46	46	50	46	46
Current ratio(x)					
	1.1	1.2	1.2	1.3	1.5
Quick ratio(x)					
	1.1	1.1	1.1	1.2	1.3
Asset/equity(x)					
	3.4	3.3	2.9	2.6	2.3
Net debt/equity					
	-155%	-123%	-116%	-112%	-108%
EBITDA interest coverage(x)					
	49.9	34.6	31.3	49.3	85.4
ROE					
	29%	34%	33%	31%	29%

Sources: Company Annual Report, CGIS Research

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