

Xinyi Glass

Lifting PT to HK\$10.50 - Near-record margins all around

Xinyi Glass (XYG) is one of China's largest and most diversified glass producers. XYG reported a 1% Y/Y increase in sales, to HK\$12.8bn, and a 52% Y/Y increase in net profits, to HK\$3.2bn. (XYG already alerted to FY16 NP growth of 40-55% Y/Y). We believe the strong earnings growth was due mainly to the surge in float glass prices since Aug-16 that is still very strong as of Feb-17. We lift our Dec-17 PT to HK\$10.50.

- Record GPM in most areas.** XYG reported a record 49% GPM for its auto glass business in 2016, a near-record 40% 2016 GPM for its construction glass and a six-year-high 2016 GPM of 27.5% for float glass, all due mostly to the rising price of float glass (much faster than the cost of production). XYG and peers are reluctant to add much new capacity to float glass due to stricter market discipline and a tougher environment for obtaining licenses and approvals for new plants that consume a great deal of energy and generate pollution. We believe the 2016 operating results were much better, but that earnings were dragged down by a jump in the tax rate due to a high tax rate for two new production bases; this has a chance to be cut significantly if the company is approved for a lower high-tech enterprise tax rate.
- Lifting earnings estimates to reflect a strong 2016 EBIT.** We are raising our FY17 and FY18 estimates mainly to reflect the much stronger-than-expected margins in 2016. We factor in another strong year for margins in 2017, but not as strong as in 2H16. We expect auto glass 2017 GPM of 48% (49.3% in 2H16), construction glass 2017 GPM of 39% (40.6% in 2H16) and float glass 2017 margin of 30% (31.2% in 2H16). We also expect strong cost controls on marketing expenses in 2017, resulting in a 13%/11% increase in 2017E/2018E EBIT. Our revised 2017E/2018E EPS is 23%/34% higher than consensus. We lift our Dec-17 PT to HK\$10.50 due to the earnings estimate revisions.
- Our revised PT implies a CY18 P/E of 8x.** Key downside risks include falling demand for construction glass that could result from a cooling property market in China, and further weakness in PV glass demand from Europe.

Overweight

0868.HK, 868 HK

Price: HK\$7.04

▲ **Price Target: HK\$10.50**
 Previous: HK\$10.00

China

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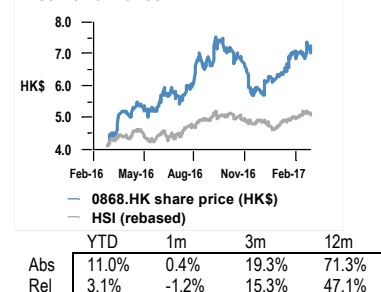
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Price Performance



Xinyi Glass (Reuters: 0868.HK, Bloomberg: 868 HK)

HK\$ in mn, year-end Dec	FY14A	FY15A	FY16E	FY17E	FY18E
Revenue (HK\$ mn)	10,861	11,460	12,848	16,750	19,357
Net Profit (HK\$ mn)	1,365	2,113	3,216	4,374	5,099
EPS (HK\$)	0.35	0.54	0.83	1.12	1.31
DPS (HK\$)	0.15	0.27	0.40	0.56	0.65
Revenue growth (%)	9.3%	5.5%	12.1%	30.4%	15.6%
EPS growth (%)	(58.9%)	54.8%	53.1%	36.0%	16.6%
ROCE	6.1%	8.3%	13.5%	16.0%	16.8%
ROE	11.1%	16.9%	24.8%	29.1%	28.2%
P/E (x)	20.2	13.0	8.5	6.3	5.4
P/BV (x)	2.2	2.2	2.1	1.6	1.4
EV/EBITDA (x)	16.3	12.1	7.8	5.9	5.0
Dividend Yield	2.1%	3.8%	5.7%	8.0%	9.3%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Shares O/S (mn)	3,687
Market Cap (HK\$ mn)	25,955
Market Cap (\$ mn)	3,344
Price (HK\$)	7.04
Date Of Price	28 Feb 17
Free Float(%)	45.2%
3M - Avg daily vol (mn)	11.12
3M - Avg daily val (HK\$ mn)	72.70
3M - Avg daily val (\$ mn)	9.4
HSI	2,3740.73
Exchange Rate	7.76
Price Target End Date	31-Dec-17
Price Target (HK\$)	10.50

See page 10 for analyst certification and important disclosures, including non-US analyst disclosures.

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Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
<ul style="list-style-type: none"> Price of float glass improving after the slack 1Q season More information on new electric (LCD) glass business to indicate sales and profit contribution Finalization of new downstream solar projects 	<ul style="list-style-type: none"> A rise in float glass price higher than our expectations, driven by strong construction demand New customers for the electric glass business of better quality than what we expect Faster completion of new electric glass lines to boost sales 	<ul style="list-style-type: none"> Further weakness in PV glass demand from Europe Falling demand for construction and float glass that may result from a cooling property market in China

Key financial metrics	FY15	FY16	FY17E	FY18E
Revenues (LC mn)	11,460	12,848	16,750	19,357
Revenue growth (%)	na	12.1%	30.4%	15.6%
EBITDA (LC mn)	2,528	3,991	5,202	6,031
EBITDA margin (%)	22.1%	31.1%	31.1%	31.2%
Tax rate (%)	11%	16%	16%	15%
Net profit (LC mn)	2,113	3,216	4,374	5,099
EPS (LC)	0.540	0.826	1.124	1.310
EPS growth (%)	na	53.1%	36.0%	16.6%
DPS (LC)	0.27	0.40	0.56	0.65
BVPS (LC)	3.25	3.39	4.32	4.98
Operating cash flow (LC mn)	2,838	3,717	4,026	4,900
Free cash flow (LC mn)	968	643	1,550	2,736
Interest cover (x)	50	52	368	457
Net margin (%)	18.4%	25.0%	26.1%	26.3%
Sales/assets (X)	0.54	0.57	0.63	0.64
Debt/equity (%)	47.4%	57.9%	45.4%	39.5%
Net debt/equity (%)	37.2%	37.1%	29.1%	21.8%
ROE (%)	17%	25%	29%	28%

Key model assumptions	FY15E	FY16E	FY17E	FY18E
Auto glass capacity (m)	16.6	17.4	18.3	19.2
Float glass capacity (mn tonnes)	5.1	5.9	6.6	7.0
Float glass price (HK\$/ton)	1,379	1,573	1,840	1,932

Source: Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
	FY17E	FY18E	FY17E	FY18E
5% chg. in float glass price	9%	9%	7%	7%
5% chg. in fuel cost	-2%	-2%	-2%	-2%
5% chg. in wage	-3%	-3%	-2%	-2%
1% chg. in GM	4%	4%	3%	3%

Source: J.P. Morgan estimates.

Peer valuation comparison

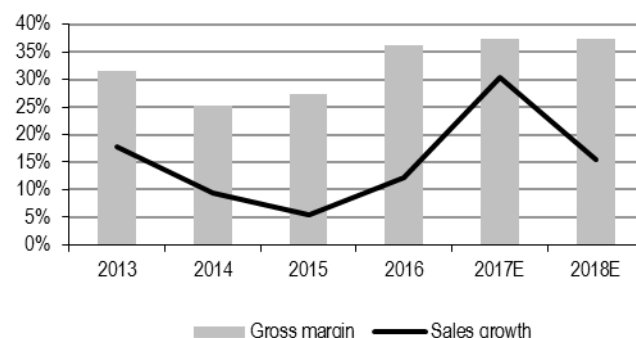
Company name	Code	Price (LC)	Mcap (US\$ M)	Vol (US\$ M)	3M chg.	P/E 16E (x)	P/E 17E (x)	ROE (%)	P/B (x)	Yld (%)
CHINA STATE CONS	3311 HK	12.7	7,307.6	13.0	1.3	11.3	8.9	21.0	1.6	2.6
ND PAPER	2689 HK	9.9	5,928.6	21.8	45.3	17.1	10.7	13.4	1.3	0.9
LM PAPER	2314 HK	7.0	4,116.7	12.4	18.1	11.4	8.7	13.4	1.7	2.9
XINYI GLASS HOLD	868 HK	7.0	3,513.5	10.0	21.8	8.5	6.3	24.8	1.4	5.7
HAITIAN	1882 HK	16.3	3,339.3	2.1	5.3	16.1	13.3	17.0	1.9	2.1
KINGBOARD CHEM	148 HK	27.5	3,654.4	7.0	26.2	5.9	6.0	12.9	0.6	5.1
CHINA LESSO	2128 HK	5.8	2,318.9	1.8	3.9	8.1	7.4	18.3	1.1	3.1
KB LAM	1888 HK	8.7	3,413.1	5.7	26.6	6.7	10.6	29.0	1.5	12.7
Average						10.1	8.7	17.1	1.3	4.4

Source: Company data, Bloomberg, J.P. Morgan estimates. Share prices are as of intraday price of 28 Feb 2017.

Valuation and price target basis

Our PT is derived from a DCF-based valuation with a WACC of 11.4% and a terminal growth rate of 3%.

Sales growth and GPM trends



Source: Bloomberg, Company and J.P. Morgan estimates.

JPM vs. consensus, change in estimates

EPS (LC)	FY17E	FY18E
JPM old	1.09	1.26
JPM new	1.124	1.310
% chg.	3%	4%
Consensus	0.91	0.979

Source: Bloomberg, J.P. Morgan estimates.

Highlights from the analyst briefing

Float glass industry healthy. XYG mentioned that the industry has rationalized after many years of tough times and low margins and that pricing power was much improved for 2016. However, XYG and peers are reluctant to add much new capacity due to stricter market discipline and a tougher environment for obtaining licenses and approvals for new plants that consume a great deal of energy and generate pollution. Management does not expect any new net capacity increase in 2017.

High taxes due to two new locations. XYG mentioned that two relatively new plants (we believe Dezhou and Yingkou) have started earning significant earnings in 2016 and are paying a 25% tax rate. Most of the other locations have applied for and received a preferential high-tech enterprise tax rate of 15%. XYG has applied for these locations to be classified as high-tech enterprises, but has not been approved as of early 2017. Given a high success rate for most of the other locations, there is a good chance that these locations will eventually enjoy a preferential rate, in our view. We factor in a relatively small 30-40% success rate in our slightly lower 2017 and 2018 tax rate assumptions.

Record GPM in most areas. XYG reported a record 49% GPM for its auto glass business in 2016, a near-record 40% 2016 GPM for its construction glass and a six-year-high 2016 GPM of 27.5% for float glass, all due mostly to the rising price of float glass (much faster than the cost of production). XYG has a policy of transferring float glass to its auto glass and construction glass division at cost. This makes the cost of the auto glass and construction glass division much more competitive than for peers that need to buy expensive float glass. Accordingly, XYG can earn higher margins for its auto glass and construction glass businesses.

FY16 results review

Float glass sales beat on volumes and prices. Sales rose 12% Y/Y due mainly to improvement in float glass sales (up 20% Y/Y) and margins.

Margin improvement. GPM rose to 36% in 2016 from 27% in 2015 due mainly to the improvement in float glass pricing and margins. Margins on auto glass also rose from 44.3% in 2015 to 49% in 2016 (a record high).

Overall in line. While 2016 EBIT was 14% higher than our expectations, the higher-than-expected tax rate resulted in 2016 NP in line with expectations.

Table 1: FY16 results

HK\$ in millions	FY15A	FY16A	Y/Y	FY16E	Var.
Turnover	11,460	12,848	12.11%	13,451	-4%
Gross profit	3,132	4,659	48.75%	4,615	1%
GPM	27.3%	36.3%		34.3%	
EBIT	2,113	3,337	57.96%	2,925	14%
EBITM	18.4%	26.0%	478.5%	21.7%	
Net profit	2,113	3,213	52.08%	3,179	1%
NP margin	18.4%	25.0%		23.6%	
EPS (HK\$)	0.53	0.82	54.40%	0.82	0%

Source: Company reports, J.P. Morgan estimates.

Lifting earnings estimates to reflect a strong 2016 EBIT

We increase our FY17 and FY18 estimates mainly to reflect the much stronger-than-expected margins in 2016. We factor in another strong year for margins in 2017, but not as strong as in 2H16. We expect auto glass GPM of 48% in 2017 (49.3% in 2H16), construction glass GPM of 39% (40.6% in 2H16) and float glass margin of 30% (31.2% in 2H16). We also expect strong cost controls on marketing expenses in 2017, resulting in a 13%/11% increase in 2017E/2018E EBIT. We assume a higher tax rate to factor in higher 2016 taxes, leaving room for a positive surprise if XYG manages to obtain a lower high-tech preferential tax rate for its newer locations. Our revised 2017E/2018E EPS is 23%/34% higher than consensus. We lift our Dec-17 PT to HK\$10.50 due to the earnings estimate revisions.

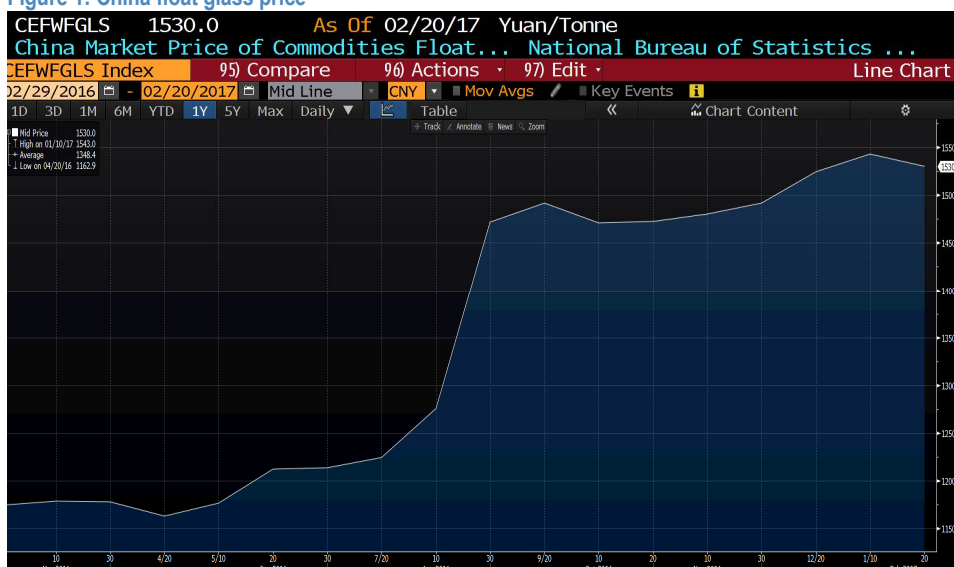
Table 2: Earnings estimate revisions

HK\$ in millions	New		Old		Change	
	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
Turnover	16,750	19,357	16,748	18,696	0.0%	3.5%
Gross profit	6,265	7,249	5,854	6,783	7.0%	6.9%
EBIT	4,310	5,062	3,810	4,570	13.1%	10.8%
Net profit	4,374	5,099	4,229	4,911	3.4%	3.8%
EPS (HK\$)	1.12	1.31	1.09	1.26	3.4%	3.8%
Assumptions						
Gross margin	37.4%	37.4%	35.0%	36.3%	2.4%	1.2%

Source: J.P. Morgan estimates.

Float glass price stubbornly strong. We normally expect float glass prices to peak in November and then fall during slack season before recovering in May. However, demand and pricing remained strong during the CNY holidays.

Figure 1: China float glass price



Source: Bloomberg (CEFWFGLS Index – 4.8mm float)

Table 5: Revenue mix

HK\$ in millions	2013	2014	2015	2016	2017E	2018E
Automobile glass	3,287	3,593	3,786	3,748	4,323	4,540
YoY	6.8%	9.3%	5.4%	-1.0%	15.4%	5.0%
% of total	33.1%	33.1%	33.0%	29.2%	26.0%	23.8%
Construction glass	2,155	2,556	2,652	2,590	3,450	4,170
YoY	36.9%	18.6%	3.8%	-2.3%	33.2%	20.9%
% of total	21.7%	23.5%	23.1%	20.2%	20.8%	21.9%
Float glass	4,494	4,269	4,671	6,010	7,915	8,831
YoY	18.9%	-5.0%	9.4%	28.7%	31.7%	11.6%
% of total	45.2%	39.3%	40.8%	46.9%	47.7%	46.3%
PV glass	0	0	0	0	0	0
YoY	45.2%	39.3%	40.8%	46.9%	47.7%	46.3%
% of total	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Electronic glass	0	443	351	475	919	1536
YoY	na	na	-20.8%	35.3%	93.4%	67.2%
% of total	0.0%	4.1%	3.1%	3.7%	5.5%	8.1%
Total revenue	9,936	10,861	11,460	12,824	16,606	19,076

Source: Company data, J.P. Morgan estimates.

Table 6: P&L statement

HK\$ in millions	2013	2014	2015	2016	2017E	2018E
Total revenues	9,936	10,861	11,460	12,848	16,750	19,357
YoY change (%)	1.5%	9.3%	5.5%	12.1%	30.4%	15.6%
Cost of goods sold	(6,799)	(8,127)	(8,328)	(8,189)	(10,485)	(12,108)
YoY change (%)	-7.0%	19.5%	2.5%	-1.7%	28.0%	15.5%
Gross profit	3,137	2,734	3,132	4,659	6,265	7,249
YoY change (%)	26.7%	-12.9%	14.6%	48.7%	34.5%	15.7%
Gross margin	31.6%	25.2%	27.3%	36.3%	37.4%	37.4%
SGA	(1,251)	(1,638)	(1,615)	(1,822)	(2,295)	(2,568)
YoY change (%)	4.5%	30.9%	-1.4%	12.9%	25.9%	11.9%
Other income/(expenses)	326	178	215	342	340	381
Operating profit	2,212	1,274	1,733	3,178	4,310	5,062
EBITDA	2,852	1,886	2,313	3,991	5,202	6,031
EBITDA margin	28.7%	17.4%	20.2%	31.1%	31.1%	31.2%
Depreciation & amortization	(639)	(612)	(580)	(812)	(892)	(969)
YoY change (%)	9.5%	-4.3%	-5.2%	40.0%	9.8%	8.6%
EBIT	2,212	1,274	1,733	3,178	4,310	5,062
EBIT margin	22.3%	11.7%	15.1%	24.7%	25.7%	26.2%
Net interest expense	(60)	(38)	(50)	(77)	(14)	(13)
Exceptional item	1,453	220	379	159	0	0
Associates	21	138	317	563	885	920
Gains/losses	0	0	0	0	0	0
Net income before taxes	3,627	1,594	2,379	3,823	5,180	5,969
YoY change (%)	159.5%	-56.1%	49.3%	60.7%	35.5%	15.2%
Tax	(381)	(228)	(266)	(607)	(807)	(870)
Effective tax rate	17.5%	16.6%	13.3%	16.6%	15.6%	14.6%
Minority interests	1	0	0	0	0	0
Net income	3,246	1,365	2,113	3,216	4,374	5,099
YoY change (%)	172.9%	-36.1%	54.8%	52.2%	36.0%	16.6%
Net margin	32.7%	12.6%	18.4%	25.0%	26.1%	26.3%

Source: Company data, J.P. Morgan estimates.

Table 7: Interim estimates

HK\$ in millions	1H15	2H15	1H16	2H16	1H17E	2H17E
Total revenues	4,883	6,577	5,885	6,963	7,672	9,078
Gross profit	1,410	1,722	2,041	2,618	2,745	3,520
EBIT	944	789	1,304	1,875	1,767	2,542
Net income before taxes	1,085	1,294	1,572	2,251	2,125	3,056
Net income	946	1,167	1,369	1,846	1,794	2,580
Diluted EPS (HK\$)	0.242	0.30	0.352	0.474	0.461	0.663
Ratios						
Revenue split	42.6%	57.4%	46%	54.2%	45.8%	54.2%
GPM	28.9%	26.2%	34.7%	37.6%	35.8%	38.8%
EBIT margin	19.3%	12.0%	22.2%	26.9%	23.0%	28.0%
NPM	19.4%	17.7%	23.3%	26.5%	23.4%	28.4%
YoY						
Revenue	-3.0%	12.9%	20.5%	5.9%	30.4%	30.4%
GP	5.5%	23.3%	44.8%	52.0%	34.5%	34.5%
EBIT	11.9%	83.2%	38.1%	137.8%	35.6%	35.6%
NP	24.2%	93.4%	44.7%	58.3%	31.0%	39.7%

Source: Company data, J.P. Morgan estimates.

Table 8: Balance sheet

HK\$ in millions	2013	2014	2015	2016	2017E	2018E
Cash and cash equivalents	1,042	831	1,298	2,763	2,762	3,435
Inventories	1,232	1,478	1,223	1,321	1,722	1,990
Accounts receivable	2,255	2,487	2,381	2,377	3,099	3,581
Other current assets	7	8	93	76	2,103	2,852
Total current assets	4,537	4,805	4,995	6,537	9,685	11,859
Intangible assets	0	0	0	0	0	0
Property and equipment, net	9,983	11,293	13,177	12,952	14,320	15,288
Other assets	5,131	4,936	3,249	4,534	4,761	4,999
Non-current assets	15,114	16,229	16,426	17,486	19,081	20,287
Total assets	19,651	21,034	21,422	24,022	28,766	32,146
Accounts payable	1,744	724	740	789	1,029	1,189
Other accrued expenses	0	1,469	1,705	1,608	2,177	2,730
Taxes payable	219	294	333	438	637	701
ST and current LT debts	2,116	2,609	2,514	3,165	2,780	2,780
Total current liabilities	4,079	4,801	4,959	6,000	6,623	7,399
Long-term debt	3,024	3,483	3,514	4,509	4,895	4,895
Other noncurrent liability	339	414	223	266	347	401
Noncurrent liabilities	3,364	3,898	3,737	4,775	5,242	5,296
Total liabilities	7,442	8,699	8,696	10,775	11,865	12,695
Share capital	4,727	3,824	3,217	3,217	3,217	3,217
Reserves and surplus	7,480	8,509	9,501	11,431	13,618	16,167
Total shareholders' equity	12,208	12,333	12,718	13,181	16,835	19,385
Minority interest	1	2	8	66	66	66
Total shareholders' equity	12,209	12,335	12,726	13,247	16,901	19,451
Total liabilities and equity	19,651	21,034	21,422	24,022	28,766	32,146

Source: Company data, J.P. Morgan estimates.

Table 9: Cash flow statement

HK\$ in millions	2013	2014	2015	2016	2017E	2018E
EBIT	2,212	1,274	1,733	3,178	4,310	5,062
Depreciation and amortization	639	644	795	812	892	969
Working capital changes	129	60	539	(8)	(569)	(324)
Tax paid	(209)	(381)	(228)	(266)	(607)	(807)
Cash flow from operations	2,772	1,598	2,838	3,717	4,026	4,900
Capital expenditures	(2,913)	(1,715)	(1,914)	(1,853)	(2,261)	(1,937)
Investments and others	(208)	32	243	(1,116)	39	38
Net interest	(60)	(38)	(50)	(77)	(14)	(13)
Cash flow from investing	(3,181)	(1,720)	(1,721)	(3,046)	(2,236)	(1,912)
Free cash flow	(409)	(123)	1,117	671	1,790	2,988
Dividends	(834)	(902)	(608)	(1,297)	(1,872)	(2,368)
Common issue	916	(3)	1	0	0	0
Other financing	688	833	(18)	2,092	81	54
Contribution from owner	0	(17)	(25)	0	0	0
Cash flow from financing	770	(89)	(650)	794	(1,791)	(2,314)
Change in cash	338	(195)	467	1,465	(1)	674
Cash beginning	703	1,042	831	1,298	2,763	2,762
Foreign exchange changes	1	(17)	0	0	0	0
Cash at end	1,042	831	1,298	2,763	2,762	3,435

Source: Company data, J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

Xinyi Glass (Overweight; Price Target: HK\$10.50)

Investment Thesis

We believe Xinyi is China's most diversified glass conglomerate. The defensive auto glass aftermarket business and the advanced low-emission construction glass business continued to do well, with stable growth and steady margins. The key driver for growth in the rest of this year is the recovery in margins for the float glass business. In the past, we have seen peak margins for float glass hit 40% when the market is in short supply. We could see margins recover when demand improves, as new supply has slowed to a trickle since the beginning of 2014.

Valuation

Our Dec-17 PT is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk-free rate of 4.2% (the yield on 10-year government notes in China). We assume a beta of 1.3 (Bloomberg beta is 1.3). Accordingly, WACC is assumed at 11.4%. We estimate free cash flow for XYG until 2020 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in 2020 (the final year of the estimate period), subject to a minimum of 3% and a maximum of 6%, depending on the nature of the industry and the level of maturity in China.

Risks to Rating and Price Target

Key downside risks include falling demand for construction glass, which may result from a cooling property market in China, and further weakness in PV glass demand from Europe.

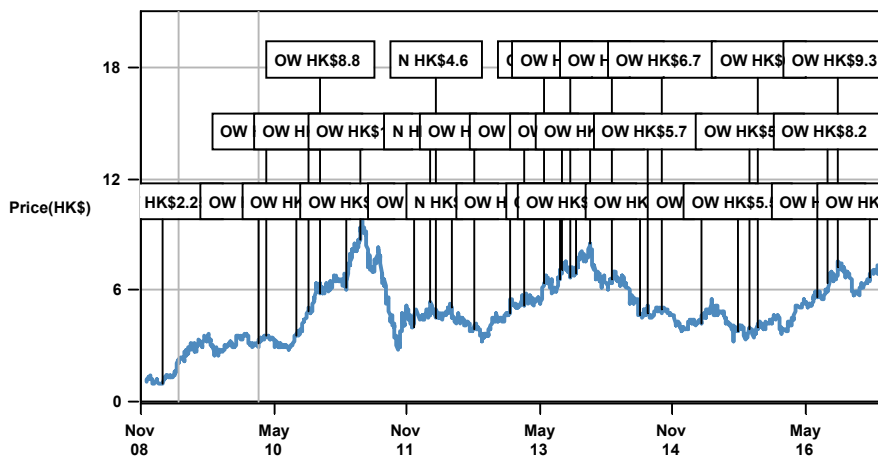
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Xinyi Glass (0868.HK, 868 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Feb 03, 2009.

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
03-Feb-09	OW	0.98	2.25
04-Mar-10	OW	3.12	4.12
31-Mar-10	OW	3.54	5.50
02-Aug-10	OW	3.51	5.70
20-Sep-10	OW	4.89	6.80
09-Nov-10	OW	5.80	8.80
01-Mar-11	OW	6.13	9.00
20-Apr-11	OW	8.77	11.00
28-Nov-11	OW	4.03	6.00
09-Feb-12	N	5.39	5.10
27-Feb-12	N	4.52	4.60
07-May-12	N	5.07	5.50
01-Aug-12	OW	3.92	5.10
31-Dec-12	OW	4.78	5.90
28-Feb-13	OW	5.21	6.90
22-May-13	OW	6.30	8.00
23-Jul-13	OW	6.58	8.70
31-Jul-13	OW	7.11	10.00
04-Sep-13	OW	6.65	10.50
26-Sep-13	OW	6.92	10.90
25-Nov-13	OW	8.53	9.80
26-Feb-14	OW	6.61	10.00
20-Jun-14	OW	4.68	6.50
24-Jul-14	OW	4.76	5.70
15-Sep-14	OW	4.92	6.70
02-Mar-15	OW	4.15	6.10
28-Jul-15	OW	3.80	5.50
10-Sep-15	OW	3.88	5.20
15-Oct-15	OW	3.97	6.00
17-Jun-16	OW	5.63	7.00
02-Aug-16	OW	6.40	8.20
07-Sep-16	OW	7.26	9.30
18-Jan-17	OW	6.68	10.00

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