Xinyi Glass (XYG) is one of China's largest and most diversified glass producers. While the sales decline in auto and construction glass was mildly disappointing, we focus on the improvement in float glass pricing and margins in our positive view on XYG and we set a new Dec-18 PT of HK$11.0.

- **Improvementinfloat la offet oter ivision** 1H17 sales growth of 13.4% y/y was 13% lower than our expectations due mainly to the weaker-than-expected recovery in auto and construction glass. However, GPM for float glass rose to 30% in 1H17 compared to 22.3% in 1H16, which helped lift overall GPM to 36.4% or 0.8% better than expected. Overall 1H17 NP was 8.8% lower than our expectations. We note that our FY17 EPS estimate was 15% higher than consensus (before the results release) and therefore we do not believe the results would be negatively received by consensus market participants. We maintain our focus on the float glass improvement with 1HFY17 GPM rising to 30% (22.3% in 1HFY16) and we expect an FY17 GPM of 32%.

- **oerin ale an net profit to refle ta toan ontr tion ale** We have lowered our sales for FY17 and FY18 by 9% and 7% due to the slower recovery in auto glass and construction glass. Our estimates for float glass remain roughly unchanged. We lower our FY17 and FY18 net profit by 5% and 6%, respectively. Our revised FY17 and FY18 EPS are now 10% and 15% higher than consensus. We set a new Dec-18 PT of HK$11.0 (prev. Dec-17 PT of HK$10.5) as the higher PT due to the rollover to Dec-18 year end is offset by earnings downward revisions.

- **rne e impie** The key downside risks are falling demand for construction glass that could result from a cooling property market in China, and further weakness in PV glass demand from Europe.

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a na ement p i i ve on flo a t la ema n Management remains positive on the sustainability of float glass demand as well as the current healthy margins. Overall construction is rising and the use of double glaze glass for residential and construction (in order to save energy) should boost demand for many years. XYG also mentioned that the quality and price premium of XYG's float glass allows the company to make superior margins while smaller and technically less sophisticated glass makers make significantly lower margins and have little incentive to expand. While new licenses for float glass facilities are increasingly difficult to obtain in the denser richer parts of Coastal China, XYG will still try to expand in order to capture market share and increase profits longer term.

o rea re i ve flo a t la e p n ion XYG is now planning up to 50% expansion in its float glass capacity from the end of 2017 to the end of 2020. This annualized increase of 14-15% is more aggressive than the average 8-9% CAGR from 2015 to 2016. They did not disclose the exact location of the new expansion (up to 8 new lines) but we expect three quarters to be in China and the rest in Malaysia and SE Asia. It is also uncertain how XYG will be able to obtain new licenses and land for expansion and we look forward to more details in the ultimate location for such expansion to see if it will trigger any oversupply or price declines.

p n ion in ala ia oin ell The company commenced its first float glass and first solar glass lines in Malaysia in late 2016 / early 2017. Management is satisfied with the performance of these lines and mentioned that the production cost is currently cheaper in Malaysia. Management has also planning to add new float and solar production lines in Malaysia over the coming years.

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- **to la i till ea er t a n e p te** We have seen a 6% y/Y drop in 1H17 auto glass sales as depreciation of many export currencies against the HK$ dragged on sales In addition, auto glass sales was weak in 2016 due to 3 main factors a) Largest customer PGW in the US had an ownership change mid-2016 and the change in management disrupted purchases from XYG b) a new anti-dumping duty from Brazil resulted in a drop in sales to that country (<3% of auto glass sales) c) rising USD resulted in many emerging markets customers buying less. These negative factors are still hurting sales growth in 1H17.

- **on tr tion la a m p re** Sales of construction glass were down 2.7% Y/Y in 1H17 after a 3% drop in sales in 2016. Sales would have been up low single digits in Rmb terms. We look for a seasonally better 2H17 to help achieve flat 2017 y/y sales growth.

- **loa t la pi e remain i even in ea omall ea** XYG achieved a GPM of 27% in 2016 when the glass price(proxy price below – 4.8 mm construction float glass) was around RMB 1,300 per ton. The average price in 2017 was RMB 1,500 per ton with an insignificant change in cost in 1H17 compared to 2016. This is the main reason for the 1H17 GPM of 30% and we currently expect 32% GPM for FY17.

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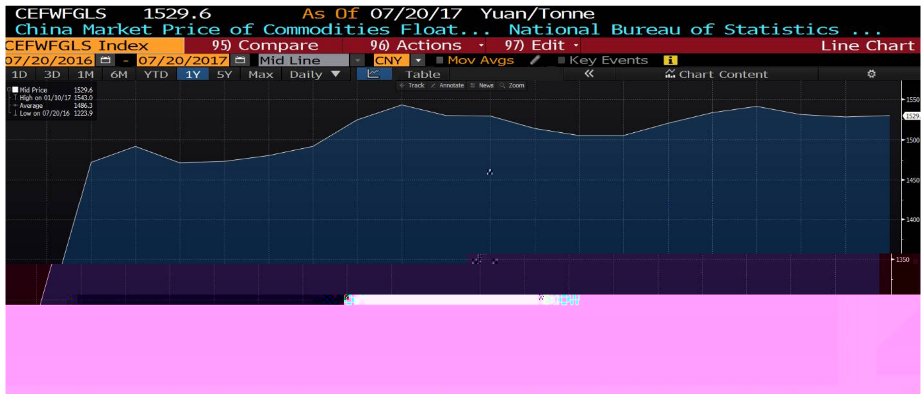

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- **if tn tli a tonan not a p i t in ina** For auto glass and construction glass, XYG is adding little to capacity in 2017 as the current utilization rates (~80% for auto glass and ~70% for construction glass) can be lifted by 5% to 10% easily to meet demand growth for at least another year.

- **pe iali e in a r to ma efloa t la** XYG normally achieve a selling price that is 15% to 20% higher than the average float glass price by specializing in and dominating certain hard to make sub-categories. While overall float glass market share is 10-12%, XYG believes that its market share for thin auto glass (2-3mm) is near 50% and for ultra-clear float (high end residential and commercial uses) is near 40% in China.

- **iffi l t to ta rtne floa t la line** With margins at near record highs in 1H17, following on a strong 2H16 (31% GPM), it is natural to plan new float glass lines in China. However, XYG believes that greenfield projects would be difficult to obtain approvals (before 2020) as the government is still keen on cutting capacity in the industry. XYG previously planned to acquire small inefficient operators and tear down the old lines and replace with larger lines. However, a more in-depth study has shown that approvals for float glass line renewals (replacements) is almost as hard to obtain as starting new lines. Accordingly, XYG is looking to expand outside of Chine. In our view, this is a phenomenon that all glass manufacturers face and the current high margins for float glass can persist for quite a while.

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D F ul i n v t a Ca o

Our Dec-18 PT is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk free rate of 4.2% (yield on 10-year government notes in China). We have assumed a beta of 1.3 (Bloomberg Beta is 1.3). Accordingly, WACC is assumed at 11.4%. We have estimated free cash flow for XYG until 2020 and assume a terminal growth rate of 3%. 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.

We also analyzed the DCF price sensitivity to WACC, and the terminal multiple.

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I nve tment e i

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.

al a ion

Our Dec-18 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.

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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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Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

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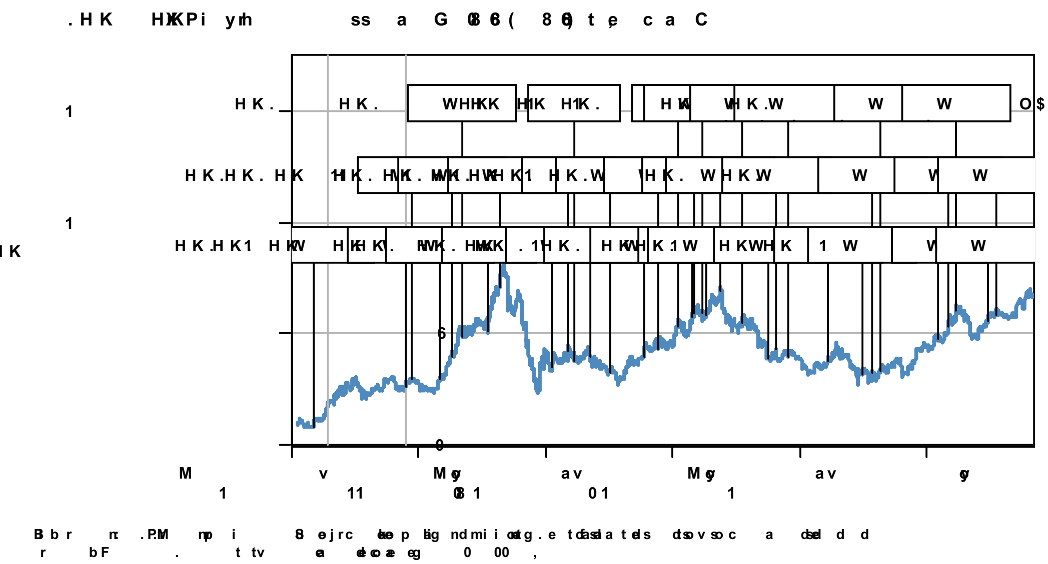

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	ver ei t (buy)	e tral (hold)	n er ei t (sell)
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