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Wasion Meters (3393.HK)

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Recommendation

Buy (Initiate Coverage)

Target price: HK\$4.35

Company profile

Wasion Meters (the Company) and its subsidiary (together the Group) are leading companies in the design, manufacture and sale of multifunction three-phase electronic power meters in the PRC.

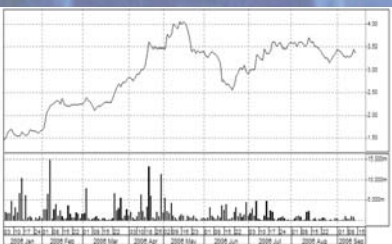
Share data

Share price (HK\$) 3.35
 Market cap. (HK\$m) 2,359
 Total issued shares (mn) 704.2
 52-week Hi/Lo (HK\$) 4.05/1.10
 Avg. daily T/O (HK\$m) 3.43
 Major share holder

-Mr. Ji 68.15%
 -Asset Managers 6.28%

Source: Company, Bloomberg

Share price movement



Source: Bloomberg

From strength to strength

Solid Industry outlook

It is increasingly common for power-related companies such as power plants and power grid companies to adopt multifunction three-phase electronic power meters to avoid billing differences. Besides, under the PRC's eleventh five-year plan, it is estimated that about RMB1.0trn will be invested in power grids. We believe, this will translated into great business opportunities for the Group going forward.

Impressive track records

Through strong R&D capability, superior product quality and clear business focus, the Group has emerged as one of the leading companies in the market for multifunction three-phase electronic meters. In fact, the Group's brand name, "Wasion", was recently awarded the title of "China's Famous Brand Name".

Strong sales growth momentum continues

In the domestic market, we expect the Group to benefit from the investment boom in power grids and the expansion of its sales network in the PRC. The sales growth from the overseas markets is also gaining momentum and we expect 6% and 7% of total sales in FY06 and FY07 respectively will be from the overseas markets. Driven by strong demand for the Group's products, new markets and additional capacity, the Group's sales is expected to grow 33% and 30% in FY06 and FY07 respectively.

Undemanding valuation

Given the Group's unique exposure to the PRC's expected investment boom in power grids and its strong earnings momentum, we believe that the counter's current valuation at FY07 PER of 12.7x is not demanding. We recommend a BUY with target price of HK\$4.35, representing FY07 PER of 16.5x.

Summary of financials

| Y/E Dec | 2004 | 2005 | 2006F | 2007F |
|--------------------|-------|-------|-------|-------|
| Sales (RMBmn) | 321 | 446 | 593 | 771 |
| Net profit (RMBmn) | 82 | 116 | 149 | 195 |
| EPS (RMB) | 0.171 | 0.230 | 0.212 | 0.273 |
| Dividend (RMB) | - | 0.069 | 0.064 | 0.082 |
| Dividend yield (%) | - | 2.0 | 1.8 | 2.4 |
| PER (x) | 20.2 | 15.0 | 16.3 | 12.7 |
| ROA (%) | 17.4 | 19.6 | 18.0 | 19.5 |
| ROE (%) | 54.6 | 36.2 | 28.5 | 30.3 |
| Net cash (RMBmn) | -69 | 144 | 156 | 169 |

Source: Company, Taiwan Securities

Strong FY06 interim results

Looking good

On the back of an 33% YoY increase in turnover to RMB204mn, the Group recorded a robust growth of 63% YoY in net profit to RMB41mn in 1H06. Due to the increased contribution from the single-phase electronic meters which command lower margin, the Group's overall gross margin was down 0.9ppt to 47.3% compared to the same period last year. However, due to greater economy of scale, the interest income from the IPO proceeds received last year and lower effective tax as a result of the tax rebate from purchasing equipment produced in the PRC, the net profit margin improved 3.6ppts to 20.1% in 1H06. The seemingly large increase of RMB12mn in the administrative expenses was partly due to the RMB5mn charge for the amortization of the options issued to employees. According to the management, the turnover in the first half is usually 35% of the full-year turnover.

Three-phase electronic meters remain the major products

Three-phase electronic meters' sales went up 28% YoY to RMB123mn and continued to be the Group's major products, accounting for 61% of the total sales during the period under review. On a lower base, single-phase electronic meters saw a robust growth of 104% YoY in sales to RMB27mn, accounting for 13% of the total sales. During the first six-month of 2006, sales of data collection terminals and power management systems recorded a growth of 22% YoY to RMB53mn, accounting for 26% of the total turnover in the period.

Stepping up sales efforts

During the period under review, the Group continued to step up sales efforts and made good progress in expanding the sales network in both the domestic and overseas markets. In the PRC, the Group added four new liaison offices, increasing the total number to 29. The liaison officers are mainly responsible for providing sales and customer support, market information collection and technical support as well. In the overseas markets, the Group successfully extended its sales network to markets in Africa and Southeast Asia, establishing sales channels in Egypt and Indonesia. During 1H06, exports accounted for 6% of the total sales, while for the full-year FY05, the figure was about 3%. According to the management, the Group is currently developing markets in the U.S. and Europe. It is expected that the prospect for the order flow from the overseas markets continues to be promising.

Industry overview

Power meters

Power meters are used to measure the transmission of electricity along the different transmission stages in the power industry, comprising generation, transmission, distribution and usage of electricity. Power meter is vital to measuring and calculating charges between power plants, power companies and energy users. As revenue of power companies is measured by the amount of electricity sold, power meters with high accuracy and reliability are used as a small measurement error could add up to huge billing differences. Power meters are generally classified into two types, namely mechanical and electronic meters. Mechanical meters are usually vulnerable to measurement error caused by wear and tear in mechanical parts and are not programmable for the transmission of data required for the modern automated power measurement systems. Therefore, it is expected that electronic power meters that are more technologically advanced and more accurate will completely replace the mechanical power meters in the future.

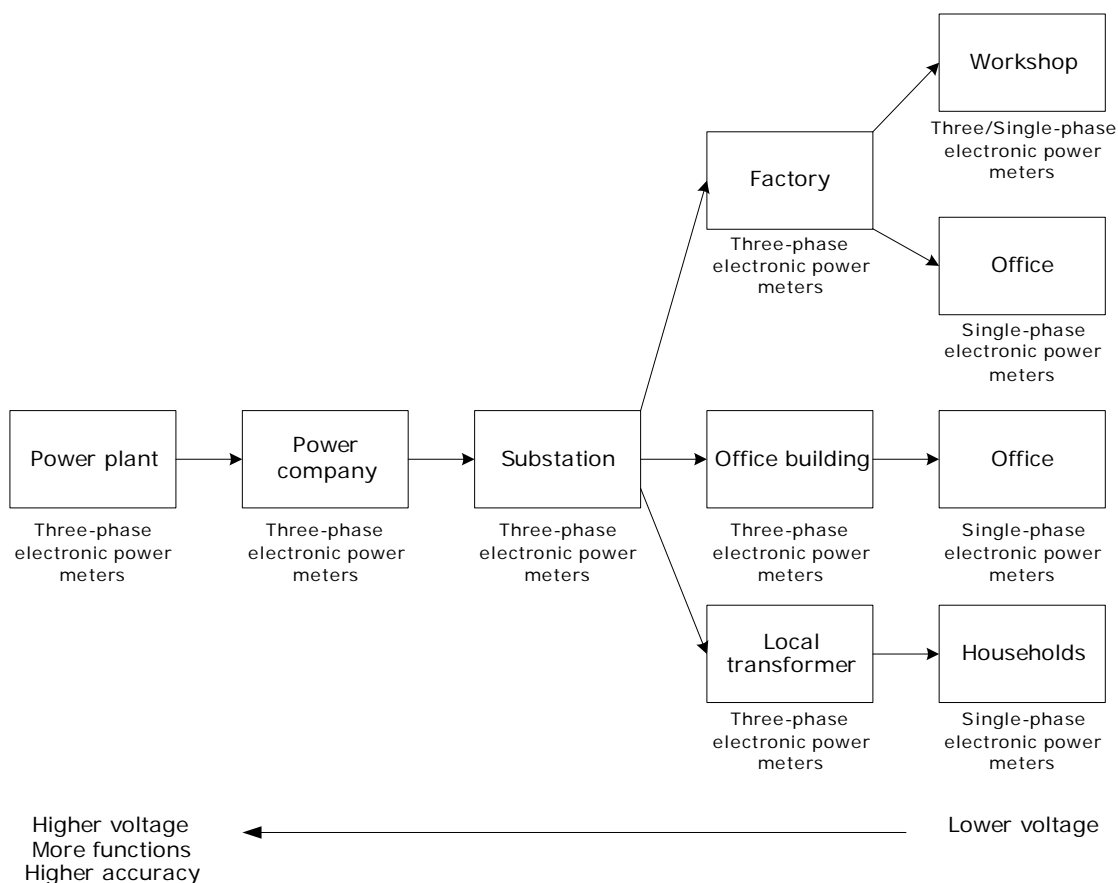
Multifunction three-phase electronic power meters

In power plants, the generation of electricity is usually three-phase which contains certain desirable properties. For instance, three-phase systems can produce a magnetic field that rotates in a specified direction, which simplifies the design of electric motors. However, most domestic loads are single phase. Generally three-phase power either does not enter domestic houses at all, or where it does, it is split out at the main distribution board. Therefore, usually three-phase electronic meters are applied in high-voltage applications such as power plants and power companies, while single-phase electronic meters are used in low-voltage applications such as office and households. Multifunction three-phase electronic power meters are at the high end of the product spectrum, which are the Group's major products.

The market for multifunction three-phase electronic power meter is less fragmented

The market for single-phase meters in the PRC is highly fragmented, as there are about 600 players competing in this market segment. However, the number of players reduces substantially to below 10 in the market for multifunction three-phase electronic power meters. According to the management, the Group has 25% share of this high-end market in terms of volume and is the largest in this niche segment. Its major competitors include Haoningda, Holley(000607.CH) and Hualong.

Figure 1-Application of electronic power meters



Source: Company, Taiwan Securities

High Entry barrier

In the high-end market for power meters, due to users' extremely high requirement for accuracy and reliability, pricing of products is not the major consideration. When choosing three-phase electronic power meters, users will put great emphasis on product providers' product quality and track records. Therefore, in this niche market, the entry barrier for new comers is high.

Favorable developments

We identify a number of favorable developments that will benefit the Group going forward. Firstly, under the PRC's eleventh five-year plan, the country's power transmission network will be expanded and the nationwide power grids will be further unified. It is estimated that over RMB1.0trn will be invested in power grids during the period of the five-year plan. Usually, for every new power interconnection between the power grids, more than one meter is applied. Secondly, the government has set the target of reducing the energy consumption per unit of GDP by about 20% during the period of the five-year plan and introduces measures to allow power tariffs to rise. The measures to save energy and raise power tariff will require a better monitor and measurement of power consumption. We believe



this will further increase the demand for electronic power meters that are more accurate and more technologically advanced. Thirdly, the PRC government plans to push forward the grid modernization. The major feature of the modernization is to achieve the automation of power data collection. For instance, the State Grid, one of the two state power-grid companies in the PRC, intends to complete by the end of 2006 the automation of power data collection for about 1,900 local power plants with installed capacity of more than 6,000MW each. At the same time, it is estimated that provincial power grid companies will have to collect and monitor real-time data of the power consumption of about 50% of the customers who consume power of more than 315kVA each in 2006. By 2010, this will further extend to all customers who consume power of 50kVA or more. We expect this will raise the demand for the Group's data collection terminals and electronic meters.

Business overview

Background

The Group is primarily engaged in the design, manufacture and sale of electronic power meters. The Group produces two types of electronic power meters, single-phase and three-phase meters. In FY05, three-phase electronic meters remained as the Group's major product, accounting for 71% of the total turnover, while single-phase meters contributed 8% of the total turnover in FY05. In 2004, the Group started tapping into the business of providing data collection and software development of power management system products. It currently offers on-site terminal server products and power management system software. Starting from a low base, contribution from these new products picked up in importance rapidly, accounting for 21% of the sales in FY05. The Group's major customers mainly consist of power-related companies such as power plants and power grid companies, accounting for about 85% of the total sales. Compared to its competitors, the Group's key competitive edges include its R&D capability, its leading position in the market segment and its clear focus on electronic power meters.

Table 1-Revenue mix

| Y/E Dec | 2002 | 2003 | 2004 | 2005 | 2006F | 2007F |
|------------------------------|------|------|------|------|-------|-------|
| Sales revenue (RMBmn) | | | | | | |
| Three-phase meters | 171 | 245 | 281 | 315 | 379 | 478 |
| Single-phase meters | 44 | 22 | 30 | 35 | 71 | 100 |
| Data collection terminals | - | - | 9 | 85 | 130 | 177 |
| Power management sys. | - | - | 1 | 10 | 12 | 15 |
| Total | 215 | 267 | 321 | 445 | 593 | 771 |
| Sales revenue mix (%) | | | | | | |
| Three-phase meters | 80 | 92 | 88 | 71 | 64 | 62 |
| Single-phase meters | 20 | 8 | 9 | 8 | 12 | 13 |
| Data collection terminals | - | - | 3 | 19 | 22 | 23 |
| Power management sys. | - | - | 0 | 2 | 2 | 2 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Company, Taiwan Securities

Strong R&D capability

Due to the Group's philosophy of maintaining its core competitive edges through product innovation, the Group has put serious efforts in building up its R&D capability. Currently, the number of the Group's R&D staff amounts to 300, or about 30% of its total employees. Relying on this strong R&D force, the Group is able to develop the built-in software specially designed for its electronic power meters and tap into the business of software development of power management system products.

A leading brand name

The Group started to engage in the business of production and sale of electronic power meters in 2000 and was one of the first few companies in the PRC to enter this market segment. Enjoying the first mover advantage and riding the wave of the substantial investment in the power industry and power grid expansion during the past few years, the Group has gradually emerged as one of major companies in the design, manufacture and sale of three-phase electronic power meters in the PRC. In fact, the Group's brand name, "Wasion" was recently awarded the title of "China's Famous Band Name" and none of its competitors has ever been awarded this honor before. We believe, the award is the recognition of the Group's superior product quality, constant product innovation and wide acceptance among its customers. With its established brand name, we expect that the Group will be able to maintain a strong relationship with its existing customers and secure new customers as well.

A clear focus on electronic power meters

From the very beginning of entering the market for power meters, the Group has been focusing on the development and production of electronic power meters. In our view, this clear focus has helped the Group building up the related technological know-how and production expertise faster, responding to customers' demand in a more efficient way and achieving better progress in product innovation. We believe, the Group is more dedicated to the electronic power meter business than its competitors. For instance, Holley, one of the major competitors, has other business focuses as well and power meters are just one of the businesses. In fact, it was recently reported that Holley planned to shift its focus to the medical business. We believe, going forward the Group will continue to benefit from its clear business focus.

The major beneficiary of the government policies

Power up ahead

As mentioned previously, the PRC government plans to invest substantially in the upgrade of power grids during the period of eleventh five-year plan. It is expected that the demand for power measurement equipment will grow in tandem with the investment in power grids. It is estimated that 6 to 8% of the total investment in power grids per year will go to power meters, automated power management system and related terminals. Besides, the government's recent measures to raise power tariff are expected to boost the demand for electronic power meters and power management systems that can measure and monitor power consumption more accurately. With its leading position in the market and the impressive track records of providing total solutions for power measurement and management, the Group will be the major beneficiary of the favorable policies.

Single-phase electronic meters are gaining momentum

During 1H06, the sales from single-phase electronic meters increased 104% YoY to RMB27mn, compared to the same period last year. In our view, the strong sales growth of single-phase electronic meters is due to the fact that the government measures to encourage energy saving and raise power tariffs boost the demand for more accurate power meters. The management expects the sales growth of single-phase electronic meters to be strong going forward. Currently, the Group outsources the production of single-phase electronic meters and this is why the gross margin for the products is only 5%. According to the management, if the sales of single-phase electronic meters reach critical mass, the Group will consider producing the products themselves and the gross margin for the products will increase to 35%.

New products

Leveraging on its strong R&D capability, the Group continues to push forward product innovation. For instance, the Group firstly tapped into the business of providing data collection and software development of power management system products in 2004. In 1H06, the Group launched new high-end products such as 0.2S and MB power series. Currently the Group is developing the power monitoring and rectifying product. This new high-end product is designed to cater for the customer's demand for high standard of electricity supply. The quality of electricity supply is usually measured in terms of aspects such as the electricity supply's voltage, frequency and voltage fluctuation. For instance, electronic equipments are designed to operate in a narrow band of voltages. Electronic equipments can have a no optimum life or performance or may even become unsafe if operated outside the voltage band. The



Group's new products are designed to monitor the quality of electricity supply and provide solutions to improve the quality of the supply when the quality is not desirable. We see good potential in this product and will include contribution from this new product in our financial models when the new product is officially launched in the future.

Gaining new grounds

In the domestic markets, we expect the Group will continue to step up its sales efforts to build up new liaison offices in major provinces, facilitating better communication with customer and faster response to customers' need. Leveraging on its leading technological know-how and impressive track records of providing products of superior quality, we believe the Group will be able to gain market share from its domestic competitors, especially those who are not as dedicated to the power meter market such as Holley. Regarding the overseas market, the outlook is promising as well. Apart from tapping the markets in the developing countries, the Group is also planning to enter the markets in the developed regions such as the U.S and Europe. We believe, the Group is well positioned to compete in the overseas markets. Compared to players in the developing regions, the Group has better technological know-how, while compared to player in the developed regions, the Group enjoys substantial cost advantage. Going forward, we expect the oversea market provides an additional source of growth for the Group.

New capacity

As of 1H06, the Group has an annual production capacity of 360k units for three-phase electronic meters. The Group is expected to expand production capacity to meet the continued growth in demand for electronic meters and related products. For instance, with the capex of RMB55mn for FY06, the Group's annual production capacity for three-phase electronic meters is expected to rise to 450k units by the end of 2006.

Valuation

Strong earnings momentum

We expect that the strong demand for electronic power meters and data collection terminals will help the Group sustain a strong earning momentum ahead. We expect the Group's net profit to achieve a CAGR of 33% for the period of FY04-FY07.

Strong financial position

During 1H06, the Group had net cash of RMB19mn on hand and its financial position is very strong. With the continued momentum in earnings, we expect the Group's cash flows to be strong going forward. We expect the dividend payout to be at least 30%.

High trade receivables are not a concern

Trade and other receivables as a percentage of sales revenue rose to 162% in 1H06. This was mainly because the Group had to grant a credit period of over 180 days to its major customers including power grid companies and power plants. According to the management, it is a normal practice for power grid companies and power plants to ask for long credit period. However, these power-related companies have never defaulted on payment to the Group and it had nod bad debt from them so far.

Stable margin ahead

About 85% of the cost of sales is from raw materials which mainly include electronic components such as single-chip microcomputer, digital IC and capacitors. As electronic components see continued pricing pressure, we expect the Group's cost structure will stay steady going forward. The decline in the overall gross margin during 1H06 was mainly due to the increased sales contribution from the lower-margin single-phase electronic meters. We expect the growth in the sales of the single-phase products will further drag down the gross margin by one to two ppts in the comings years. However, if the sales of the single-phase products reach critical mass, the Group will produce the products in-house and the gross margin for the single-phase products can rise to 35%. Overall, we expect the Group will be able to maintain the gross margin above 45% in the coming years.

Target price representing FY07 PER of 16.5x

We like the Group's close relationships with power-related companies such as power grid companies and power plants. Given the Group's business model, we expect it to benefit from the PRC's investment in power grids over the coming few years. Given the Group's unique exposure to the PRC's expected investment boom in power grids and its strong earnings momentum, we believe that the counter's current valuation at FY07 PER of 12.7x is not demanding. We recommend a BUY with target price of HK\$4.35, representing FY07 PER of 16.5x.

**Table 2–Key financials**

| Y/E Dec | 2004 | 2005 | 2006F | 2007F |
|-------------------------|-------------|-------------|--------------|--------------|
| Sales (RMBmn) | 321 | 446 | 593 | 771 |
| Chg in sales (%) | 20 | 39 | 33 | 30 |
| Gross profit (RMBmn) | 158 | 235 | 292 | 368 |
| Chg in gross profit (%) | 22 | 48 | 24 | 26 |
| EBITDA (RMBmn) | 107 | 156 | 182 | 233 |
| Chg in EBITDA (%) | 36 | 46 | 16 | 28 |
| EBIT (RMBmn) | 98 | 137 | 163 | 214 |
| Chg in EBIT (%) | 31 | 39 | 20 | 31 |
| Net profit (RMBmn) | 82 | 116 | 149 | 195 |
| Chg in net profit (%) | 28.8 | 40.7 | 28.7 | 30.8 |
| Gross margin (%) | 49.4 | 52.8 | 49.3 | 47.8 |
| EBITDA margin (%) | 33.4 | 35.1 | 30.7 | 30.3 |
| EBIT margin (%) | 30.5 | 30.6 | 27.5 | 27.8 |
| Net profit margin (%) | 25.5 | 26.0 | 25.2 | 25.3 |

Source: Company, Taiwan Securities

Appendix

Income Statement

| Y/E Dec (RMBmn) | 2004 | 2005 | 2006F | 2007F |
|-------------------------------|------------|------------|------------|------------|
| Turnover | 321 | 446 | 593 | 771 |
| Cost of sale | (163) | (210) | (301) | (402) |
| Gross profit | 158 | 235 | 292 | 368 |
| Other revenue | 1 | 3 | 5 | 6 |
| Other net income | 0 | 0 | 0 | 0 |
| Distribution costs | (28) | (45) | (55) | (71) |
| R&D costs | (7) | (15) | (17) | (22) |
| Administrative expenses | (20) | (33) | (54) | (58) |
| Other operating expenses | (6) | (8) | (8) | (9) |
| Profit from operations | 98 | 137 | 163 | 214 |
| Finance costs | (10) | (12) | (9) | (10) |
| Income tax | (6) | (8) | (5) | (9) |
| Net profit | 82 | 116 | 149 | 195 |

Source: Company, Taiwan Securities

Balance Sheet

| Y/E Dec (RMBmn) | 2004 | 2005 | 2006F | 2007F |
|-----------------------------|------------|------------|------------|------------|
| Total assets | | | | |
| Fixed assets | 76 | 89 | 122 | 142 |
| Intangible assets | 57 | 53 | 50 | 50 |
| Other LT assets | 12 | 11 | 11 | 11 |
| Inventories | 80 | 85 | 124 | 167 |
| Trade and other receivables | 144 | 247 | 302 | 401 |
| Pledged deposits | 42 | 52 | 52 | 52 |
| Cash and cash equivalents | 26 | 206 | 254 | 267 |
| Total Liabilities | | | | |
| Trade and other payables | 129 | 152 | 182 | 222 |
| Bank loans | 137 | 40 | 120 | 75 |
| Current taxation | 3 | 6 | 5 | 6 |
| Bank loans | - | 75 | 30 | 75 |
| Shareholders' funds | 169 | 472 | 577 | 712 |

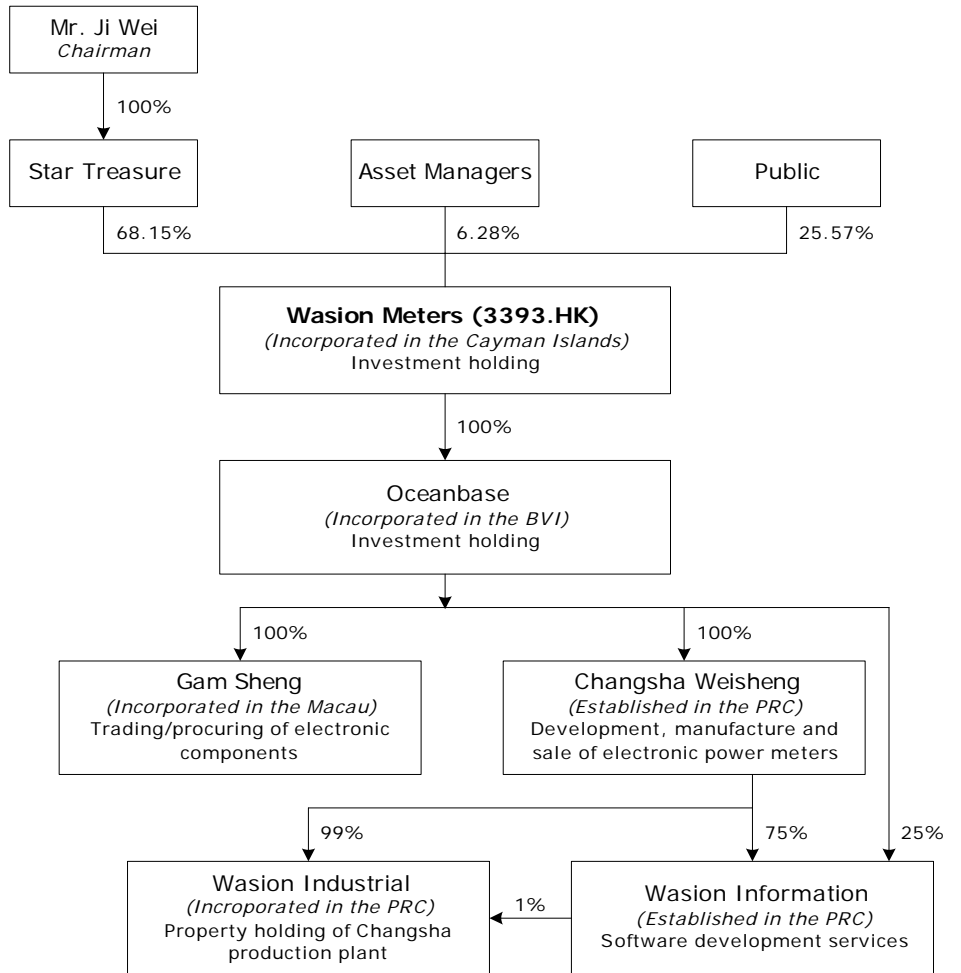
Source: Company, Taiwan Securities

Cash Flow

| Y/E Dec (RMBmn) | 2004 | 2005 | 2006F | 2007F |
|-----------------------------|-------------|-------------|-------------|-------------|
| Operating cash flow | 35 | 61 | 121 | 131 |
| Profit before tax | 88 | 124 | 154 | 204 |
| Depreciation & amortization | 9 | 20 | 19 | 19 |
| Change in working capital | (69) | (90) | (63) | (103) |
| Others | 7 | 7 | 11 | 11 |
| Investing cash flow | 20 | (23) | (49) | (39) |
| Capex | (18) | (23) | (55) | (45) |
| Others | 38 | 0 | 6 | 6 |
| Financing cash flow | (58) | 143 | (25) | (70) |
| Net cash flow | (2) | 181 | 48 | 23 |

Source: Company, Taiwan Securities

Group structure



Source: Company, Taiwan Securities

Distribution network in the PRC



Source: Company

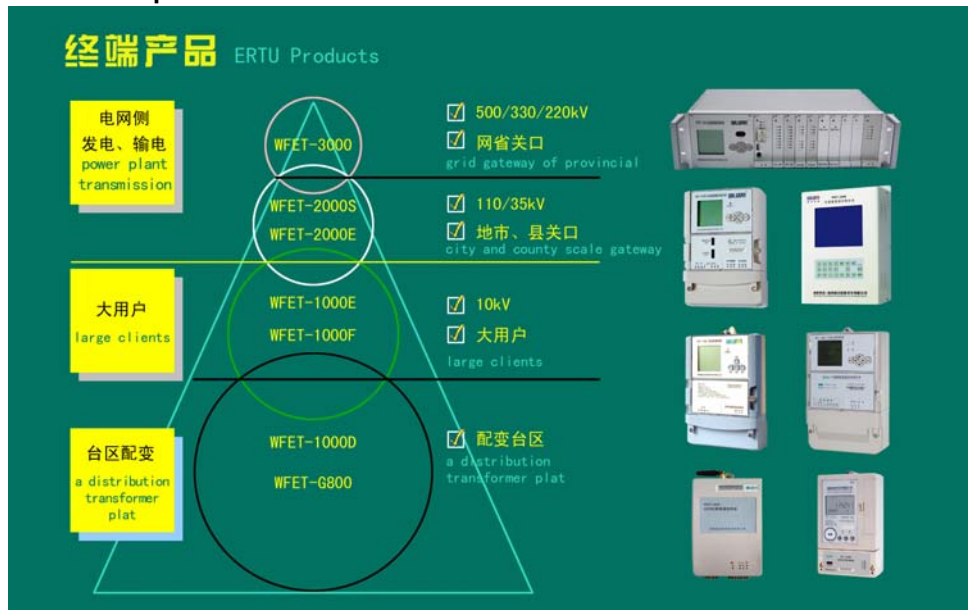
Pictures of the Group's products

Multifunction three-phase electronic power meter



Source: Company

Terminal products



Source: Company

Power monitoring system



Source: Company

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