

# China Lesso Group Holdings Ltd.

Bloomberg: 2128 HK Equity | Reuters: 2128.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

10 Feb 2022

## BUY

Last Traded Price (9 Feb 2022): HK\$13.86 (HSI : 24,830)  
Price Target 12-mth: HK\$20.70 (49% upside) (Prev HK\$23.00)

### Analyst

Patricia YEUNG +852 36684189 patricia\_yeung@dbs.com  
Ian CHUI CFA, +852 36684174 ianchui@dbs.com

### What's New

- Customer base diversification and better credit collection to mitigate property sector challenges
- GP margin to rebound in FY22-23 as power curb impacts dissipate
- Entry into solar business to align with China's carbon emission goals
- Maintain BUY with HK\$20.7 TP; recent correction an overreaction to property market risks

### Price Relative



### Forecasts and Valuation

FY Dec (RMBm)	2020A	2021F	2022F	2023F
Turnover	28,073	31,789	35,151	39,090
EBITDA	6,196	6,248	7,429	8,842
Pre-tax Profit	4,754	4,538	5,737	7,199
Net Profit	3,751	3,444	4,355	5,465
EPS (RMB)	1.21	1.11	1.40	1.76
EPS (HK\$)	1.48	1.36	1.72	2.16
EPS Gth (%)	23.1	(8.2)	26.5	25.5
Diluted EPS (HK\$)	1.48	1.36	1.72	2.16
DPS (HK\$)	0.44	0.50	0.65	0.84
BV Per Share (HK\$)	7.83	8.79	9.98	11.47
PE (X)	9.4	10.2	8.1	6.4
P/Cash Flow (X)	9.6	7.0	6.2	5.2
P/Free CF (X)	20.2	14.0	9.6	7.3
EV/EBITDA (X)	7.0	6.8	5.4	4.2
Net Div Yield (%)	3.2	3.6	4.7	6.1
P/Book Value (X)	1.8	1.6	1.4	1.2
Net Debt/Equity (X)	0.4	0.3	0.2	0.0
ROAE(%)	20.6	16.4	18.3	20.1
Earnings Rev (%):		(20)	(17)	New
Consensus EPS (RMB)		1.35	1.58	1.76
Other Broker Recs:		B:14	S:0	H:0

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

## Property market concerns overdone

### Investment Thesis

**Actively managing property sector-related risks.** China Lesso continues to diversify its customer base away from property developers. The company sees firm demand from state-owned enterprises, infrastructure projects, and agriculture. China Lesso also prioritised credit collection terms, giving up high-risk orders. We reckon the recent price correction is an overreaction to property market-related fears.

**Gross margin to rebound by 1ppt to c.29% in FY22.** GPM of the core piping business is expected to narrow slightly in 2HFY21 due to impacts from China's power curbs. The company has retained its ability to pass on increases in PVC raw material costs. We reckon these impacts should dissipate in FY22-23.

**Formed new solar business to align with China's "30-60" carbon emission goals.** China Lesso plans to sell BAPV and eventually BIPV products and services in this new business. Although initial contributions are small, the new business indicates the company's determination to capture opportunities in China's green transformation.

### Valuation:

We fine-tuned our FY21-22 earnings to reflect impacts from China's power curbs. The TP of HK\$20.7 is based on 12x target PE on our FY22F EPS, near the low end of A-share plastic pipe manufacturing peers.

### Where we differ:

Our FY22 earnings estimate is 12% lower than that of the market consensus as we are more conservative on gross margin.

### Key Risks to Our View:

Slowdown in infrastructure investments and real estate development. Abrupt volatility in raw material and energy costs.

### At A Glance

Issued Capital (m shrs)	3,102
Mkt Cap (HK\$m/US\$m)	42,994 / 5,519
Major Shareholders (%)	
Wong (Luen Hei)	68.4
Free Float (%)	31.6
3m Avg. Daily Val. (US\$m)	8.77
GICS Industry: Industrials / Capital Goods	



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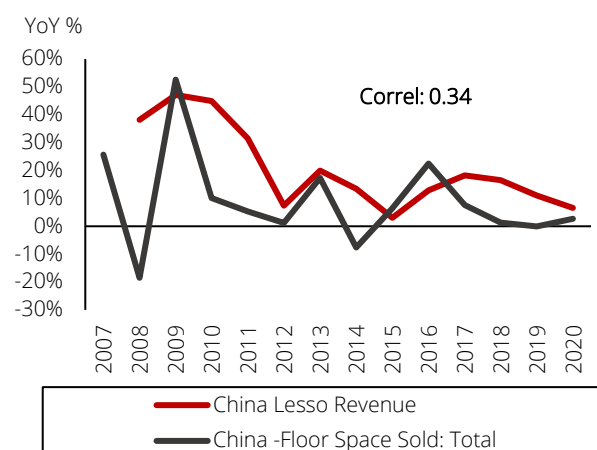
### WHAT'S NEW

#### Property market concerns overdone

The ongoing property sector-driven liquidity crisis has driven China Lesso's share price down as much as 52% from the peak of HK\$21.6 reached in Jun 21. We reckon the de-rating is overdone. The current valuation of just c.8x FY22 PE has not reflected three key initiatives. First, China Lesso is actively minimising its revenue risk from the China property sector. Second, the company's pipe product gross margin should rebound in FY22-23 as impacts from power curbs are likely transitory. Third, China Lesso is entering the solar product business, increasing its alignment with China's "30-60" carbon reduction goals.

**Active mitigation of credit risk from China's property developers.** We reckon the market is overreacting to China Lesso's property sector related risks. China Lesso's revenue growth was positive every year throughout 2007-2020 even when the growth of GFA sold has at times turned negative. In our analysis, China Lesso's revenue growth rate shows limited correlation of 0.34 with the growth rate of total GFA sold in China during 2007-20. This correlation is even lower at 0.32 if compared with the growth rate of residential GFA sold in the same period.

#### China Lesso's revenue vs. floor area sold in China



Source: CEIC, China Lesso

China Lesso is also taking steps to mitigate the fallout from the credit crunch led by China's property developers. The company redoubled its efforts on collecting receivables due to uncertainty regarding the credit risk, reducing high-

risk orders. Trade receivable days stayed at a manageable 51 days as at Jun 21 (Dec 20: 46 days). We estimate a 10% write down of China Lesso's FY22 trade receivables would result in a 7% impact to FY22 EPS. The company has also tightened terms for its orders, prioritising cash on delivery (COD). Secondly, the company continues to diversify its customer base. As at Jun-21 no single external customer accounted for >10% of China Lesso's total revenue. The company is also intentionally shifting its customer mix away from residential property developers towards more creditworthy clients. These include state-owned enterprises and municipal government-led projects. Demand from the agriculture sector for China Lesso's pipes also stayed steady. The company is seeing increased applications of its pipes in aquaculture and hydroponic farming.

According to our China property research team, the government has taken various property-specific support measures since Sep-21. These include (1) urging banks to accelerate mortgage approvals and cash disbursement; (2) lower mortgage interest rates; (3) encouraging local governments to support local demand; and (4) NDRC, PBOC, CBIRC, NAFMII, etc. conducting frequent meetings with developers to ensure market stability. Effective implementation of support policies could eventually remove the overhang on the property sector and China Lesso.

**China's infrastructure spending to support building material segment.** In the building material business, China Lesso has taken steps to diversify its customer mix towards government-led infrastructure projects. The policy backdrop remains supportive of this view. To illustrate, media reported the Chinese Government is looking to expedite government infrastructure spending in 2022. In Dec 21, the Ministry of Finance (MOF) reportedly fast-tracked the issuance of Rmb1.46tn of local government special bonds. Proceeds from the special bond issuance are targeted towards various infrastructure developments in the transport, agriculture, and water sectors, among others. This decision came before the official decision on the special bond quota for 2022. The 2022 quota is expected to be announced in Mar 22 at the National People's Congress. For reference, the 2021 special bond quota was Rmb3.65tn. Growth from government-led infrastructure initiatives should help offset a demand

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slowdown from property developers. Shrugging off COVID-19 impacts, China Lesso was able to grow its building material segment revenue 31% y-o-y in FY20. With revived policy-driven infrastructure spending, we reckon China Lesso can sustain the growth trajectory for this segment. Against this backdrop, we estimate building material segment revenue to grow 30% y-o-y for FY22-23.

**Gross margin to rebound in FY23 as power curb impacts dissipate in FY22.** We have lowered our FY21 and FY22 overall gross margin assumptions from 30.2% and 30.9% to 27.6% and 28.7%, respectively, due to several reasons. Firstly, China Lesso has already used up batches of lower cost PVC in 1HFY21. Prices of newer batches of PVC pipe were elevated in 2HFY21 due to a supply crunch. This was attributable to China's power curbs in 3Q21, which constrained the production of PVC factories. As a result, PVC prices surged >50% in Oct 21. As at Jan 22, PVC prices have corrected c.33% to pre-power curb levels, thanks to restored supply. Secondly, the power curbs also constrained China Lesso's own production. As such, the company had to bear some of the fixed expenses such as labor incurred during the power curb. However, **China Lesso continues to retain its ability to pass on raw material costs.** Looking ahead to 2022, we reckon normalised PVC supply should lead to broadly stable COGS at pre-power curb levels. China Lesso's own production is also not expected to be disrupted by power curbs again. Considering stable feedstock and normal production levels, overall gross margin could rebound to >29% in FY23.

**Entry into solar business to align with China's "30-60" carbon goals.** In Jan 22, China Lesso announced the formation of a new photovoltaic business under the umbrella of Guangdong Lesso Banhao Photovoltaic New Energy Co. (Lesso Banhao). The company plans to provide integrated energy solutions to industrial, commercial, and household customers. These include sale and design of solar panels and aftermarket servicing. Initially, Lesso Banhao will sell building applied photovoltaics (BAPV) solutions to China Lesso's existing customers, particularly at industrial parks. The company has allocated three production lines to assemble the BAPV products. The initial investment in the new business is minimal and should be financed with internal resources. In the long term, China Lesso views Banhao as an upgrade to its building material segment. The company is investing resources in research and development, with the aim to develop leading building-integrated photovoltaic (BIPV) products and solutions.

We are positive about China Lesso's entry into the solar business, given the alignment with China's "30-60" carbon reduction goals. According to an estimate from China Academy of Building Research (CABR), China has c.80bn sm of building site area in 2021. This represents a good potential addressable market for BAPV and BIPV. The Chinese Government has also issued various supportive policies for BIPV. In Jun 21, the National Energy Administration (NEA) proposed a pilot programme for distributed solar. Roof tops at selected cities for the pilot programs will aim to achieve BIPV coverage of 50%, 40% 30% and 20% on government structures, schools/hospitals, commercial/industrial structures, and rural residential structures. In Oct 21, the Ministry of Housing and Urban Rural Development (MOHURD) issued binding regulations for energy saving and usage of renewable energy in construction. In Jan 22, the State Council issued a work plan regarding energy conservation and emission reduction. Within the work plan there was specific guidance regarding green buildings and reiteration of support for BIPV.

The new business at Lesso Banhao also has the added benefit of serving China Lesso's existing customers rather than new customers. This should help offset some of the softening demand from residential property development. Furthermore, the eventual entry into BIPV should raise the overall technical sophistication of the building material segment. While still in its early stages, the contribution of the solar business to Lesso's financial statements is limited. However, eventual scaling of this business should act as a revenue driver and help sustain gross margins. We reckon continued news flow on the back of the development of the solar business, should lift the sentiment on China Lesso and improve its valuation.

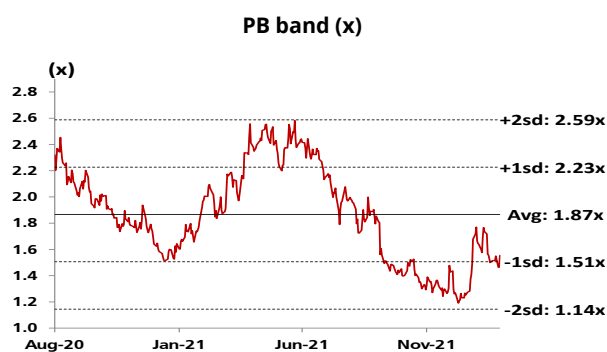
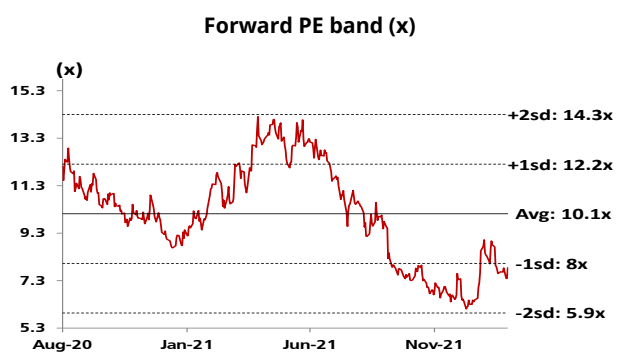
Given our more cautious margin assumptions, our FY21-22 EPS estimates are adjusted down by 20-17%. China Lesso is currently trading at c.8x FY22 PE, slightly above its 5-year average of 7x. Given the company's efforts to diversify its customer base, we reckon the recent share price correction was an overreaction to property market-related fears. The current valuation also has not factored in the potential of the new solar business. We maintain our BUY recommendation on China Lesso with HK\$ 20.7 TP by rolling our valuation basis forward to FY22. The target price is pegged to 12x target PE on our FY22 EPS estimate, near the low end of China Lesso's plastic pipe manufacturing peers. News flow on easing for China's property sector and/or potential rebound in residential construction activity could act as a positive catalyst.

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### Company Background

Listed on the Hong Kong Stock Exchange in 2010, Lesso is a leading industrial manufacturer of plastic pipes, building materials, and interior decoration products in China. It has a comprehensive product range with over 10,000 product types, ranging from piping systems, sanitary ware products, integrated kitchens, systems of doors and windows to decorative plates, fire-fighting equipment, and sanitary materials.

### Historical PE and PB band



Source: Thomson Reuters, DBS HK

## China Lesso Group Holdings Ltd.

### Key Assumptions

FY Dec	2019A	2020A	2021F	2022F	2023F
Capacity of pipes (mn ton)	2.8	3.0	3.3	3.5	3.8
Sales volume of pipes (mn ton)	2.4	2.6	2.6	2.9	3.1
Pipe ASP (Rmb/ton)	9,887.0	9,395.0	10,417.3	10,329.0	10,254.9
Sales growth of environmental protection (%)	73.4	8.6	10.0	15.0	15.0
Sales growth of supply chain services platform (%)	2.2	81.8	30.0	30.0	30.0

Source: Company, DBS HK

### Segmental Breakdown (RMB m)

FY Dec	2019A	2020A	2021F	2022F	2023F
<b>Revenues (RMB m)</b>					
Plastic piping systems	23,709	24,512	27,335	29,534	31,980
Building materials and interior decoration products	1,519	1,997	2,596	3,375	4,387
Environmental protection	326	354	389	448	515
Supply chain services platform (Lesso Home)	379	689	896	1,164	1,514
Others	412	521	573	630	693
<b>Total</b>	<b>26,345</b>	<b>28,073</b>	<b>31,789</b>	<b>35,151</b>	<b>39,090</b>
<b>Gross profit (RMB m)</b>					
Plastic piping systems	6,852	7,407	7,463	8,365	9,545
Building materials and interior decoration products	266	479	675	911	1,228
Environmental protection	127	138	152	184	221
Supply chain services platform (Lesso Home)	72	131	179	245	333
Others	220	279	306	337	371
<b>Total</b>	<b>7,537</b>	<b>8,434</b>	<b>8,775</b>	<b>10,041</b>	<b>11,699</b>
<b>Gross profit Margins (%)</b>					
Plastic piping systems	28.9	30.2	27.3	28.3	29.8
Building materials and interior decoration products	17.5	24.0	26.0	27.0	28.0
Environmental protection	39.0	39.0	39.0	41.0	43.0
Supply chain services platform (Lesso Home)	19.0	19.0	20.0	21.0	22.0
Others	53.5	53.5	53.5	53.5	53.5
<b>Total</b>	<b>28.6</b>	<b>30.0</b>	<b>27.6</b>	<b>28.6</b>	<b>29.9</b>

Source: Company, DBS HK

## China Lesso Group Holdings Ltd.

### Income Statement (RMB m)

FY Dec	2019A	2020A	2021F	2022F	2023F
Revenue	26,345	28,073	31,789	35,151	39,090
Cost of Goods Sold	(18,807)	(19,689)	(23,014)	(25,110)	(27,391)
<b>Gross Profit</b>	<b>7,537</b>	<b>8,384</b>	<b>8,775</b>	<b>10,041</b>	<b>11,699</b>
Other Opg (Exp)/Inc	(3,085)	(3,399)	(3,777)	(4,045)	(4,380)
<b>Operating Profit</b>	<b>4,452</b>	<b>4,985</b>	<b>4,998</b>	<b>5,997</b>	<b>7,319</b>
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	107	204	97	177	197
Net Interest (Exp)/Inc	(577)	(436)	(557)	(437)	(317)
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
<b>Pre-tax Profit</b>	<b>3,982</b>	<b>4,754</b>	<b>4,538</b>	<b>5,737</b>	<b>7,199</b>
Tax	(954)	(996)	(1,087)	(1,374)	(1,724)
Minority Interest	(4)	(7)	(7)	(8)	(9)
Preference Dividend	0	0	0	0	0
<b>Net Profit</b>	<b>3,025</b>	<b>3,751</b>	<b>3,444</b>	<b>4,355</b>	<b>5,465</b>
Net Profit before Except.	3,025	3,751	3,444	4,355	5,465
EBITDA	5,585	6,196	6,248	7,429	8,842
<b>Growth</b>					
Revenue Gth (%)	11.0	6.6	13.2	10.6	11.2
EBITDA Gth (%)	26.7	10.9	0.9	18.9	19.0
Opg Profit Gth (%)	26.0	12.0	0.2	20.0	22.0
Net Profit Gth (%)	21.4	24.0	(8.2)	26.5	25.5
<b>Margins &amp; Ratio</b>					
Gross Margins (%)	28.6	29.9	27.6	28.6	29.9
Opg Profit Margin (%)	16.9	17.8	15.7	17.1	18.7
Net Profit Margin (%)	11.5	13.4	10.8	12.4	14.0
ROAE (%)	19.3	20.6	16.4	18.3	20.1
ROA (%)	8.0	8.6	7.3	9.1	11.1
ROCE (%)	11.4	11.3	10.1	12.2	14.8
Div Payout Ratio (%)	36.8	29.7	37.0	38.0	39.0
Net Interest Cover (x)	7.7	11.4	9.0	13.7	23.1

Source: Company, DBS HK

## China Lesso Group Holdings Ltd.

### Balance Sheet (RMB m)

FY Dec	2019A	2020A	2021F	2022F	2023F
Net Fixed Assets	9,395	9,900	11,139	11,835	12,467
Invt in Associates & JVs	1,511	2,407	2,407	2,407	2,407
Other LT Assets	12,147	14,552	14,712	14,813	14,907
Cash & ST Invt	6,362	7,447	5,888	5,165	5,197
Inventory	3,966	5,127	5,805	6,419	7,139
Debtors	3,539	4,320	4,382	4,438	4,504
Other Current Assets	3,864	2,775	3,023	3,247	3,510
<b>Total Assets</b>	<b>40,785</b>	<b>46,528</b>	<b>47,356</b>	<b>48,324</b>	<b>50,130</b>
ST Debt	11,411	7,364	5,364	3,364	1,364
Creditors	8,737	8,307	9,703	10,630	11,665
Other Current Liab	379	387	387	387	387
LT Debt	1,267	8,082	7,082	6,082	5,082
Other LT Liabilities	1,897	2,033	2,033	2,033	2,033
Shareholder's Equity	16,576	19,841	22,266	25,299	29,061
Minority Interests	518	513	520	529	538
<b>Total Cap. &amp; Liab.</b>	<b>40,785</b>	<b>46,528</b>	<b>47,356</b>	<b>48,324</b>	<b>50,130</b>
Non-Cash Wkg. Capital	2,253	3,527	3,121	3,088	3,101
Net Cash/(Debt)	(6,316)	(7,999)	(6,558)	(4,282)	(1,249)
Debtors Turn (avg days)	43.3	51.1	50.0	45.8	41.7
Creditors Turn (avg days)	158.3	166.5	150.4	155.6	156.1
Inventory Turn (avg days)	76.8	88.8	91.3	93.5	94.9
Asset Turnover (x)	0.7	0.6	0.7	0.7	0.8
Current Ratio (x)	0.9	1.2	1.2	1.3	1.5
Quick Ratio (x)	0.5	0.7	0.7	0.7	0.7
Net Debt/Equity (X)	0.4	0.4	0.3	0.2	0.0
Net Debt/Equity ex MI (X)	0.4	0.4	0.3	0.2	0.0
Capex to Debt (%)	41.6	12.4	20.1	21.2	31.0

Source: Company, DBS HK

### Cash Flow Statement (RMB m)

FY Dec	2019A	2020A	2021F	2022F	2023F
Pre-Tax Profit	3,982	4,754	4,538	5,737	7,199
Dep. & Amort.	997	1,006	1,154	1,256	1,326
Tax Paid	(773)	(996)	(1,087)	(1,374)	(1,724)
Assoc. & JV Inc/(loss)	(107)	0	0	0	0
(Pft)/ Loss on disposal of FAs	(128)	(7)	(7)	(8)	(9)
Chg in Wkg.Cap.	634	(1,274)	406	33	(13)
Other Operating CF	708	162	0	0	0
<b>Net Operating CF</b>	<b>5,312</b>	<b>3,645</b>	<b>5,004</b>	<b>5,643</b>	<b>6,779</b>
Capital Exp.(net)	(5,275)	(1,908)	(2,500)	(2,000)	(2,000)
Other Invt.(net)	(60)	(1,956)	0	0	0
Invt in Assoc. & JV	(7)	(895)	0	0	0
Div from Assoc & JV	19	0	0	0	0
Other Investing CF	1,259	342	(52)	(52)	(52)
<b>Net Investing CF</b>	<b>(4,063)</b>	<b>(4,417)</b>	<b>(2,552)</b>	<b>(2,052)</b>	<b>(2,052)</b>
Div Paid	(867)	(893)	(1,018)	(1,323)	(1,704)
Chg in Gross Debt	539	2,768	(3,000)	(3,000)	(3,000)
Capital Issues	(85)	0	0	0	0
Other Financing CF	120	(19)	7	8	9
<b>Net Financing CF</b>	<b>(293)</b>	<b>1,857</b>	<b>(4,011)</b>	<b>(4,314)</b>	<b>(4,694)</b>
Currency Adjustments	13	0	0	0	0
Chg in Cash	969	1,085	(1,559)	(723)	32
Opg CFPS (RMB)	1.52	1.59	1.48	1.81	2.19
Free CFPS (RMB)	0.01	0.56	0.81	1.17	1.54

Source: Company, DBS HK

**China Lesso Group Holdings Ltd.**

**Target Price & Ratings History**



S.No.	Date	Closing Price	12-mth Target Price	Rating
1:	30-Mar-21	HK\$16.84	HK\$19.50	Buy
2:	28-Jun-21	HK\$18.92	HK\$23.00	Buy

Source: DBS HK

Analyst: Patricia YEUNG  
Ilan CHUI CFA,



## China Lesso Group Holdings Ltd.

DBS HK recommendations are based on an Absolute Total Return\* Rating system, defined as follows:

**STRONG BUY** (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return, i.e., > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

\*Share price appreciation + dividends

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Sources for all charts and tables are DBS HK unless otherwise specified.

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**DBS Bank (Hong Kong) Limited**

13<sup>th</sup> Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong

Tel: (852) 3668-4181, Fax: (852) 2521-1812

**China Lesso Group Holdings Ltd.**

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**DBS Regional Research Offices**

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**HONG KONG**

**DBS Bank (Hong Kong) Ltd**

**Contact: Carol Wu**

13th Floor One Island East,

18 Westlands Road, Quarry Bay, Hong Kong

Tel: 852 3668 4181

Fax: 852 2521 1812

e-mail: [dbsvhk@dbs.com](mailto:dbsvhk@dbs.com)

**MALAYSIA**

**AllianceDBS Research Sdn Bhd**

**Contact: Wong Ming Tek (128540 U)**

19th Floor, Menara Multi-Purpose, Capital Square,

8 Jalan Munshi Abdullah 50100, Kuala Lumpur, Malaysia.

Tel.: 603 2604 3333

Fax: 603 2604 3921

e-mail: [general@alliancedbs.com](mailto:general@alliancedbs.com)

Co. Regn No. 198401015984 (128540-U)

**SINGAPORE**

**DBS Bank Ltd**

**Contact: Janice Chua**

12 Marina Boulevard,

Marina Bay Financial Centre Tower 3

Singapore 018982

Tel: 65 6878 8888

e-mail: [groupresearch@dbs.com](mailto:groupresearch@dbs.com)

Company Regn. No. 196800306E

**INDONESIA**

**PT DBS Vickers Sekuritas (Indonesia)**

**Contact: Maynard Priajaya Arif**

DBS Bank Tower

Ciputra World 1, 32/F

Jl. Prof. Dr. Satrio Kav. 3-5

Jakarta 12940, Indonesia

Tel: 62 21 3003 4900

Fax: 6221 3003 4943

e-mail: [indonesiaresearch@dbs.com](mailto:indonesiaresearch@dbs.com)

**THAILAND**

**DBS Vickers Securities (Thailand) Co Ltd**

**Contact: Chanpen Sirithanarattanakul**

989 Siam Piwat Tower Building,

9th, 14th-15th Floor

Rama 1 Road, Pathumwan,

Bangkok Thailand 10330

Tel. 66 2 857 7831

Fax: 66 2 658 1269

e-mail: [research@th.dbs.com](mailto:research@th.dbs.com)

Company Regn. No 0105539127012

Securities and Exchange Commission, Thailand