

Weichai Power-H (2338 HK)

Correction offers buying opportunity; Diversification strategy on track

Weichai's share price has dropped 8% since the release of 2019 results. We see the correction a good buying opportunity as we believe the growth drivers are well intact: (1) the inclusion of more Shandong SOEs under SHIG, parent company of Weichai, will help boost Weichai's sales; (2) the diversification into non-road machinery engine is on track; (3) macro policy to support infrastructure spending should boost the demand for construction trucks. We trimmed our 2020E/21E earnings estimates by 7%/4% on lower margin projection and lower sales estimates on overseas business that operated by KION (KGX GR). Our SOTP-based TP is adjusted to HK\$16.0 from HK\$17.9.

- Gross margin contraction should not be an ongoing trend.** Gross margin in 4Q19 narrowed 3.2ppt YoY and 1.8ppt QoQ to 21.1%. Management explained that the reason for the lower margin in 4Q19 was due to a change in product mix. The strong sales of certain type of logistic trucks in China boosted the demand for Weichai's WP10H product (which carried lower margin compared with that of the high margin 12L engines). That said, we do not expect a continuous margin contraction, given Weichai's strong bargaining power on the back of consolidating industry.
- More opportunities following the consolidation of Sinotruk and Lovol Heavy Industry by SHIG.** In Oct 2019, SHIG was granted in Oct 2019 20.8% state-owned shares of Lovol Heavy Industry, a company that manufactures construction and agricultural machinery. This opens up a new opportunity to Weichai. Weichai targets to achieve annual sales of 100k units of continuously variable transmission (CVT) powertrain to Lovol in future. Meanwhile, given the consolidation and management reshuffle of Sinotruk have largely been completed, we expect Sinotruk will focus on sales volume growth going forward. Weichai targets to achieve annual sales of 100k-200k units of MDT and LDT engines in future. All these, together with the expansion in hydraulic powertrain and high-speed large-bore engine, will help Weichai achieve much higher level of diversification over the coming few years.
- Risk factors:** (1) weakness in HDT and engine demand; (2) further downside risk on overseas business; (3) technology risk.

Earnings Summary

(YE 31 Dec)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (RMB mn)	159,256	174,361	178,460	191,703	199,752
YoY growth (%)	5.1	9.5	2.4	7.4	4.2
Net income (RMB mn)	8,658	9,105	9,737	10,695	11,309
EPS (RMB)	1.08	1.15	1.23	1.35	1.43
YoY growth (%)	27.2	6.0	6.9	9.8	5.7
Consensus EPS (RMB)	n/a	n/a	1.25	1.31	1.29
P/E (x)	9.7	9.4	8.9	8.1	7.7
EV / EBITDA (x)	4.5	4.3	4.2	3.9	3.7
P/B (x)	2.1	1.9	1.7	1.5	1.3
Yield (%)	4.4	2.7	4.5	5.5	5.9
ROE (%)	23.2	21.5	19.9	19.1	18.0
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIS estimates

BUY (Maintain)

Target Price	HK\$16.00
(Previous TP)	HK\$17.90
Up/Downside	+33%
Current Price	HK\$12.06

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Stock Data

Mkt Cap (HK\$ mn)	102,886
Avg 3 mths t/o (HK\$ mn)	93
52w High/Low (HK\$)	17.3/10.73
Total Issued Shares (mn)	1,934 (H) 5,991 (A)

Source: Bloomberg

Shareholding Structure

Weichai Holdings Group	16.8%
Weifang Investment Group	3.7%
Free float (H-share)	24.2%
Free float (A-share)	55.3%

Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-21.4%	-11.3%
3-mth	-25.2%	-18.2%
6-mth	6.7%	-11.2%

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

Auditor: Ernst & Young

Related Reports

- China Construction Machinery Sector - Scenario analysis on the resumption of factory production – 10 Feb 2020
- China Heavy Duty Truck Sector – Potential change in market share due to Wuhan Pneumonia – 29 Jan 2020
- China Construction Machinery Sector – Four structural drivers to extend the upcycle to 2020-21E – 27 Nov 2019

Key takeaways from post-result conference

Core business:

- **About margin in 4Q19.** Management explained the reason for the lower margin in 4Q19 was due to a change in product mix. The strong sales of certain type of logistic trucks in China boosted the demand for Weichai's WP10H product (which carries lower margin compared with that of the high margin 12L engines).
- **Synergy effect will be seen following the corporate restructuring. Sinotruk (3808 HK, BUY)** will increase the procurement of Weichai's engine. Medium-duty trucks (MDT) and light-duty truck (LDT) will all be equipped with Weichai's engines. The volume will potentially increase to 100k-200k units per year. However, such sales will not affect Sinotruk's in-house production of MC11 and MC13 engines.
- **Weichai believes HDT demand will be resilient over the coming 3-5 years.** There are currently ~2mn units of NES III trucks in operation, which will be eliminated going forward. Besides, easing monetary policy will boost infrastructure spending this year, which will drive further demand.
- **Hydraulic components for excavator industry.** In China, there are ~100k units of excavator currently using imported hydraulic components (Total market size: RMB 10b-15bn). Weichai has been actively expanding into this segment in order to achieve import substitution. Weichai will focus on hydraulic powertrain, with a key focus on 15t to 20t (or above). Weichai will leverage its advantage on the technology of electric motor, and believes it's capable of achieving 50% market share in future.
- **CVT powertrain.** Weichai has been working on the development of CVT powertrain systems for agricultural tractors (150 horsepower or above). Lovol Heavy Industry, an agricultural equipment manufacturer (Weichai's sister company), will procure 100k units of agricultural engine from Weichai.
- **High speed large-bore engine:** The large-bore diesel engine market is currently dominated by the overseas manufacturers such as Caterpillar, Cummins, MTU Liebherr and Mitsubishi. Global market size reached 150-200k units, mainly in the overseas. Weichai is leveraging the technology of Baudouin (a French company acquired by Weichai 10 years ago) to expand into the large-bore high-speed engine segment.
- **Revenue contribution from industrial engine.** Weichai exported 20k units of industrial engine in 2019, and targets to achieve 40k units in 2020E. Weichai expects revenue contribution of 30-40% in 3-5 years.

KION Group:

- In China, KION is shifting from high-end to mid-end to drive sales.
- COVID-19 will inevitably affect KION and Linde in the overseas market.

Fuel cell battery commercial vehicles:

- Shandong province has abundant supply of hydrogen
- City public transportation / port vehicles are suitable to apply fuel cell battery technology.

Long-term sales target:

- **Engine:** 2mn units
- **Hydraulic powertrain:** 100k units
- **Gearbox:** 2mn units
- **Shaanxi Heavy Motor HDT:** 200k units

R&D and capex:

- 5% of revenue will be spent on R&D every year.
- Capex upcycle in the coming three years with an annual budget of RMB7bn.

Dividend payout ratio:

- Dividend cut due to COVID-19
- Payout ratio will increase after COVID-19 under control

2019 Results Highlights

Weichai's net profit in 2019 increased 5% YoY to RMB9.1bn, 6%/5% below our/consensus estimates. While revenue in 2019 is 2% above our expectation, the discrepancy came from a lower gross margin in 4Q19, which narrowed 3.2ppt YoY to 21.1%.

- **Sales volume growth in line with expectation.** Total sales of engine / gear box grew 10.1% / 10.2% YoY in 2019. Sales volume of HDT increased moderately by 5% to 161k units, above the industry average growth of 2%.
- **Lower payout ratio expected.** The proposed final dividend implies that the full year dividend payout ratio is 38%, down from 59% in 2018. This is expected as Weichai highlighted in the interim result that it would keep more cash for R&D and upcoming investment.
- **Guidance for 2020E:** As at end-2019, Weichai's order on hand amounted to RMB38.4bn. Weichai targets to achieve 8% revenue growth in 2020E.

Figure 1: 4Q19 results highlights

(RMB mn)	1Q18	1Q19	Change (YoY)	2Q18	2Q19	Change (YoY)	3Q18	3Q19	Change (YoY)	4Q18	4Q19	Change (YoY)
Revenue	39,212	45,212	15%	43,052	45,651	6%	35,919	35,846	0%	41,073	47,653	16%
Cost of sales	-30,159	-35,420	17%	-34,177	-35,681	4%	-28,272	-27,653	-2%	-31,079	-37,599	21%
Gross profit	9,053	9,792	8%	8,875	9,969	12%	7,647	8,193	7%	9,995	10,053	1%
Other income	117	128	9%	26	211	711%	92	99	7%	287	330	15%
Other gains and losses	-67	113	n/a	240	60	-75%	102	225	120%	210	30	-86%
S&D expenses	-2,638	-2,736	4%	-2,835	-2,634	-7%	-2,406	-2,575	7%	-2,739	-3,309	21%
Administrative and R&D expenses	-2,280	-2,560	12%	-2,667	-3,119	17%	-2,347	-2,800	19%	-3,286	-3,649	11%
Taxes and surcharges	-217	-189	-13%	-182	-186	2%	-107	-95	-12%	-217	-194	-10%
Impairment loss of assets	-515	-226	-56%	230	-226	n/a	-144	-77	-46%	-415	-207	-50%
EBIT	3,453	4,323	25%	3,687	4,075	11%	2,837	2,970	5%	3,836	3,053	-20%
Other expenses	-27	-43	61%	-26	13	n/a	-50	-22	-56%	50	-42	-184%
Net finance cost	-200	-108	-46%	144	-33	n/a	-43	0	-101%	24	-79	-427%
Finance income and others	-	-	-	-	-	-	-	-	-	-	-	-
Finance expenses	-	-	-	-	-	-	-	-	-	-	-	-
Share of profit of JV and associates	19	11	-38%	118	112	-5%	23	19	-17%	15	102	587%
Pretax profit	3,244	4,183	29%	3,923	4,167	6%	2,767	2,967	7%	3,924	3,034	-23%
Income tax	-684	-811	19%	-601	-647	8%	-602	-531	-12%	-346	-456	32%
After tax profit	2,561	3,373	32%	3,322	3,520	6%	2,165	2,436	13%	3,578	2,578	-28%
MI	-641	-781	22%	-849	-824	-3%	-556	-666	20%	-922	-531	-42%
Net profit	1,920	2,591	35%	2,473	2,696	9%	1,609	1,771	10%	2,656	2,047	-23%
Key ratios			Change (ppt)			Change (ppt)			Change (ppt)			Change (ppt)
Gross margin	23.1%	21.7%	-1.4	20.6%	21.8%	1.2	21.3%	22.9%	1.6	24.3%	21.1%	-3.2
S&D expenses ratio	6.7%	6.1%	-0.7	6.6%	5.8%	-0.8	6.7%	7.2%	0.5	6.7%	6.9%	0.3
Administrative and R&D expenses ratio	5.8%	5.7%	-0.2	6.2%	6.8%	0.6	6.5%	7.8%	1.3	8.0%	7.7%	-0.3
Effective tax rate	21.1%	19.4%	-1.7	15.3%	15.5%	0.2	21.8%	17.9%	-3.9	8.8%	15.0%	6.2

Source: Company data, CMBIS

Figure 2: 2019 results highlights

(RMB mn)	2018	2019	Change (YoY)	2019E	A vs E
Revenue					
Diesel engines	44,858	49,976	11%	49,600	0.8%
Automobiles and major components	66,848	71,475	7%	70,209	1.8%
Forklift trucks & supply chain solution	60,540	67,177	11%	63,567	5.7%
Intersegment sales	-12,990	-14,267	10%	-12,836	11.1%
Total revenue	159,256	174,361	9%	170,540	2.2%
Segment profit					
Diesel engines	7,310	7,573	4%	8,482	-10.7%
Automobiles and major components	1,963	2,176	11%	2,645	-17.7%
Forklift trucks & supply chain solution	3,636	3,992	10%	3,814	4.7%
Intersegment sales	128	-131	-202%	-128	1.8%
Total segment profit	13,037	13,610	4%	14,812	-8.1%
Segment margin					
			Change (ppt)		Diff (ppt)
Diesel engines	16.3%	15.2%	-1.14	17.1%	-1.95
Automobiles and major components	2.9%	3.0%	0.11	3.8%	-0.72
Forklift trucks & supply chain solution	6.0%	5.9%	-0.06	6.0%	-0.06
Average	8.2%	7.8%	-0.38	8.7%	-0.88
Interest income	1,060	1,067	1%	1,275	-16.3%
Dividend income and unallocated income	949	1,056	11%	950	11.1%
Corporate and unallocated expenses	-52	-94	79%	-205	-54.1%
Finance expenses	-1,135	-1,288	13%	-1,285	0.2%
Pretax profit	13,858	14,352	4%	15,548	-7.7%
Income tax	-2,233	-2,445	10%	-2,519	-2.9%
After tax profit	11,626	11,907	2%	13,029	-8.6%
MI	-2,968	-2,802	-6%	-3,296	-15.0%
Net profit	8,658	9,105	5%	9,733	-6.5%
Key ratios					
			Change (ppt)		
Gross margin	22.3%	21.8%	-0.5	22.4%	-0.60
S&D expenses ratio	6.7%	6.5%	-0.2	0.0%	6.45
Administrative and R&D expenses ratio	6.6%	7.0%	0.3	0.0%	6.96
Effective tax rate	16.1%	17.0%	0.9	16.2%	0.83

Source: Company data, CMBIS

Figure 3: Change in key assumptions

Change in key assumptions	2020E			2021E		
	Old	New	Change	Old	New	Change
(RMB mn)						
Revenue						
Diesel engines	53,073	53,530	0.9%	56,154	56,621	0.8%
Automobiles and major components	68,115	72,895	7.0%	69,255	77,470	11.9%
Forklift trucks & supply chain solution	66,745	66,505	-0.4%	70,083	73,156	4.4%
Intersegment sales	-13,503	-14,470	7.2%	-14,087	-15,543	10.3%
Total revenue	179,391	178,460	-0.5%	187,155	191,703	2.4%
Segment profit						
Diesel engines	9,075	8,565	-5.6%	9,546	9,116	-4.5%
Automobiles and major components	2,452	2,187	-10.8%	2,493	2,402	-3.7%
Forklift trucks & supply chain solution	4,005	3,658	-8.7%	4,205	4,316	2.6%
Intersegment sales	-135	-145	7.2%	-141	-155	10.3%
Total segment profit	15,655	14,265	-8.9%	16,391	15,678	-4.3%
Segment margin						
			Change (ppt)			Change (ppt)
Diesel engines	17.1%	16.0%	-1.1	17.0%	16.1%	-0.9
Automobiles and major components	3.6%	3.0%	-0.6	3.6%	3.1%	-0.5
Forklift trucks & supply chain solution	6.0%	5.5%	-0.5	6.0%	5.9%	-0.1
Average	8.7%	8.0%	-0.7	8.8%	8.2%	-0.6

Source: Company data, CMBIS estimates

Figure 4: SOTP valuation

SOTP valuation	Valuation methodology	Target multiple (x)	EBITDA 2020E (RMB mn)	Estimated EV (RMB mn)	Net cash / (Net debt)	Equity value (RMB mn)
Weichai core business	EV/EBITDA	6	12,669	76,013	24,881	100,894
KION Group	Proportionate market value	-	-	-	-	15,870
Share of JV/associates	PB	1.5	-	-	-	7,067
Minority interest (Weichai core business)						-10,140
Total NAV						113,691
NAV per share (RMB)						14.3
NAV per share (HK\$)						16.0

Source: Company data, CMBIS estimates

Financial Summary

Income statement						Cash flow summary					
YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E	YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	159,256	174,361	178,460	191,703	199,752	Pretax profit	13,858	14,352	15,436	17,181	18,240
Cost of sales	-123,686	-136,353	-139,199	-149,337	-155,607	Finance cost	1,135	1,288	1,299	1,272	1,255
Gross profit	35,569	38,008	39,261	42,366	44,145	Interest income	-1,060	-1,067	-1,604	-1,924	-2,267
Operating expenses	-21,757	-23,586	-24,154	-25,851	-26,926	Share of profit or loss of associates	-174	-244	-238	-243	-248
EBIT	13,812	14,422	15,107	16,516	17,219	Depreciation	5,321	6,188	6,059	6,598	7,137
Other expenses	-52	-94	-214	-230	-240	Amortization of intangible assets	2,016	1,820	1,863	1,863	1,863
Net finance cost	-75	-220	305	652	1,013	Income tax paid	-2,233	-2,445	-2,624	-2,921	-3,101
Finance income and others	1,060	1,067	1,604	1,924	2,267	Change in working capital	2,363	2,603	-1,182	727	-985
Finance expenses	-1,135	-1,288	-1,299	-1,272	-1,255	Others	1,035	1,341	1,604	1,924	2,267
profit of JV & associates	174	244	238	243	248	Cash flow from operation	22,262	23,835	20,613	24,478	24,161
Pretax profit	13,858	14,352	15,436	17,181	18,240	Net capex on PP&E	-1,952	-4,278	-7,000	-7,000	-7,000
Income tax	-2,233	-2,445	-2,624	-2,921	-3,101	Investment in JV/associates	-1,655	-243	0	0	0
After tax profit	11,626	11,907	12,812	14,260	15,139	Investment in subsidiaries	0	0	0	0	0
MI	-2,968	-2,802	-3,075	-3,565	-3,830	Dividend received	181	135	143	146	149
Net profit	8,658	9,105	9,737	10,695	11,309	Others	-3,754	-4,004	0	0	0
						Cash flow from investing	-7,181	-8,391	-6,857	-6,854	-6,851
D&A	7,404	8,071	7,922	8,461	9,000	Proceeds from equity financing	0	0	0	0	0
EBITDA	21,216	22,493	23,029	24,977	26,220	Net bank borrowings	635	1,137	-900	-400	-400
						Dividend paid	-4,039	-4,851	-2,269	-3,895	-4,813
						Interest paid	0	0	-1,299	-1,272	-1,255
						Others	-3,577	-3,853	0	0	0
						Cash flow from financing	-6,980	-7,567	-4,468	-5,566	-6,467
						Change in cash	8,100	7,877	9,288	12,057	10,843
						Cash at beginning of the year	34,222	38,210	48,818	58,105	70,162
						Exchange gains/(losses) and others	-4,112	2,731	0	0	0
						Cash at the end of the year	38,210	48,818	58,105	70,162	81,005

Balance sheet						Key ratios					
YE 31 Dec (RMB mn)	FY18A	FY19A	FY20E	FY21E	FY22E	YE 31 Dec	FY18A	FY19A	FY20E	FY21E	FY22E
Non-current assets	97,171	110,647	109,819	108,455	106,554	Sales mix (%)					
PP&E	29,453	26,319	27,259	27,661	27,523	Diesel engines	28.2	28.7	30.0	29.5	29.6
Investment in JV/associates	4,464	4,711	4,806	4,903	5,002	Automobiles and major components	42.0	41.0	40.8	40.4	39.7
Goodwill	23,037	23,823	23,823	23,823	23,823	Other components	38.0	38.5	37.3	38.2	38.8
Long term receivables	6,483	8,448	8,448	8,448	8,448	Import & export services	(8.2)	(8.2)	(8.1)	(8.1)	(8.1)
Intangible assets	23,299	23,436	21,573	19,710	17,847	Forklift trucks & supply chain	100.0	100.0	100.0	100.0	100.0
Others	10,434	23,911	23,911	23,911	23,911	Intersegment sales					
Current assets	108,105	126,185	132,567	153,039	158,851	Total	22.3	21.8	22.0	22.1	22.1
Prepayments	1,109	997	997	997	997	Profit & loss ratio (%)	8.7	8.3	8.5	8.6	8.6
Inventories	20,674	24,718	21,046	28,051	23,108	Gross margin	13.3	12.9	12.9	13.0	13.1
Trade receivables	13,155	14,285	15,051	16,462	16,374	EBIT margin	7.3	6.8	7.2	7.4	7.6
Notes receivables	24,993	26,458	26,458	26,458	26,458	After tax profit margin					
Others	9,964	10,910	10,910	10,910	10,910	Growth (%)	5.1	9.5	2.4	7.4	4.2
Cash	38,210	48,818	58,105	70,162	81,005	Revenue	7.5	6.9	3.3	7.9	4.2
						Gross profit	23.4	4.4	4.7	9.3	4.3
Current liabilities	88,617	105,877	101,889	111,132	105,215	EBIT	14.3	6.0	2.4	8.5	5.0
Trade and bills payables	30,869	36,749	32,660	41,803	35,787	Net profit	27.2	5.2	6.9	9.8	5.7
Notes payable	15,925	22,446	22,446	22,446	22,446	Balance sheet ratio					
Bank borrowings	12,371	15,013	15,113	15,213	15,313	Current ratio (x)	1.2	1.2	1.3	1.4	1.5
Others	29,451	31,669	31,669	31,669	31,669	Receivable turnover days	31	29	30	30	30
Non-current liabilities	54,400	61,180	60,180	59,680	59,180	Inventory turnover days	60	61	60	60	60
Bank borrowings	23,174	21,669	20,669	20,169	19,669	Payable turnover days	91	91	91	91	91
Long term payables	19,475	16,325	16,325	16,325	16,325	Net debt / total equity (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Others	11,751	23,186	23,186	23,186	23,186	Profitability (%)					
Equity	62,259	69,775	80,317	90,682	101,009	ROA	5.9	5.4	5.3	5.7	5.7
Shareholders' equity	39,314	45,224	52,692	59,492	65,988	ROE	23.2	21.5	19.9	19.1	18.0
MI	22,946	24,551	27,626	31,191	35,021	Per share data					
						EPS (RMB)	1.08	1.15	1.23	1.35	1.43
						BVPS (RMB)	4.96	5.70	6.64	7.50	8.32
						DPS (RMB)	0.46	0.29	0.49	0.61	0.64

Source: Company data, CMBIS estimates

Disclosures & Disclaimers

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BUY : Stock with potential return of over 15% over next 12 months
HOLD : Stock with potential return of +15% to -10% over next 12 months
SELL : Stock with potential loss of over 10% over next 12 months
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