

Jiangsu Hengli Hydraulic (601100 CH)

Solid share gain story for both short and long-term; Raise earnings est. & TP

We see potential earnings upside in 2020E-22E driven by several drivers: (1) Short term: Hengli's production plan in Dec implies 20% MoM increase in hydraulic cylinders output volume, which is surprisingly strong; (2) Medium term: Solid market share gain on the back of the rising market share of Chinese-brand excavator manufacturers (Hengli's customers); (3) Long-term: Trend of import substitution of pump & valves and other products is clear. We revise up our earnings forecast in 2020E-22E by 8-10% (9-10% above consensus), after revising up both sales volume and gross margin assumptions. We continue to like Hengli's solid position in the high-end hydraulic components industry with clear roadmap to achieve import substitution. Our TP is lifted to RMB114.4 from RMB87, based on 55x 2021E P/E (30% premium to the historical average of 42x).

- **Resilient demand for excavator in 2021E.** For the industry as a whole, major manufacturers of excavator delivered sales volume of 296k units in 11M20, up 37% YoY, according to CCMA. We expect the full year sales volume growth will reach ~40%. In 2021E, we see upside to our existing excavator demand growth forecast of 3%, driven by infrastructure spending growth and the continuous trend of the substitution of labour by excavators.
- **Hengli's growth is driven by structural factors.** We estimate a single-digit growth of excavator demand will be enough for Hengli to deliver 20% revenue growth in 2021E, given that the Chinese excavator makers (majority of them are Hengli's customers with high installation ratios), such as **SANY Heavy (600031 CH, BUY)**, are gaining market share, which will drive Hengli's share gain. We forecast Hengli's market share in hydraulic cylinder to increase from 52% in 2020E to 61% in 2022E. Besides, we expect pump & valve for large-size excavators, as well as non-standardized hydraulic components for various industries will serve as other key drivers.
- **Latest production plan suggests robust demand in 1Q21E.** According to Hengli's production plan in Dec, the scheduled production volume of hydraulic cylinder (for excavator) is expected to reach 79k units, up 20% MoM. We estimate this will translate into ~40k units for excavator demand for the industry in Jan 2021E, which is impressive given that the industry sales volume was only 9.9k units in Jan 2020. On the other hand, we expect Hengli's hydraulic pump and valves will see strong growth in Dec on MoM basis.
- **Key risks:** (1) Slowdown of construction activities; (2) risk of overseas expansion; (3) increase in raw materials cost.

Earnings Summary

| (YE 31 Dec) | FY18A | FY19A | FY20E | FY21E | FY22E |
|-----------------------|----------|----------|----------|----------|----------|
| Revenue (RMB mn) | 4,211 | 5,414 | 7,242 | 8,745 | 9,886 |
| YoY growth (%) | 50.6 | 28.6 | 33.8 | 20.7 | 13.0 |
| Net income (RMB mn) | 837 | 1,296 | 2,186 | 2,750 | 3,204 |
| EPS (RMB) | 0.64 | 0.99 | 1.67 | 2.11 | 2.45 |
| YoY growth (%) | 119.1 | 54.9 | 68.6 | 25.8 | 16.5 |
| Consensus EPS (RMB) | NA | NA | 1.53 | 1.91 | 2.25 |
| EV/EBITDA (x) | 114.0 | 76.3 | 48.2 | 39.4 | 34.8 |
| P/E (x) | 153.6 | 99.1 | 58.8 | 46.7 | 40.1 |
| P/B (x) | 28.3 | 23.0 | 17.7 | 14.1 | 11.5 |
| Yield (%) | 0.2 | 0.4 | 0.7 | 0.9 | 1.0 |
| ROE (%) | 19.9 | 25.6 | 34.1 | 33.6 | 31.5 |
| Net debt / equity (%) | Net cash | Net cash | Net cash | Net cash | Net cash |

Source: Company data, Bloomberg, CMBIS estimates

BUY (Maintain)

Target Price: RMB114.40
(Previous TP) RMB87.00
Up/Downside: +16%
Current Price: RMB98.43

China Capital Goods

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Stock Data

| | |
|--------------------------|-------------|
| Mkt Cap (RMB mn) | 128,487 |
| Avg 3 mths t/o (RMB mn) | 467 |
| 52w High/Low (RMB) | 100.5/29.24 |
| Total Issued Shares (mn) | 1,305 |

Source: Bloomberg

Shareholding Structure

| | |
|-------------------|-------|
| WANG's family | 71.0% |
| CCASS (Hong Kong) | 10.0% |
| Free float | 19.0% |

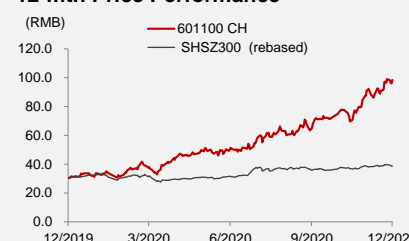
Source: Company data

Share Performance

| | Absolute | Relative |
|-------|----------|----------|
| 1-mth | 9.6% | 10.5% |
| 3-mth | 48.1% | 37.4% |
| 6-mth | 93.2% | 58.2% |

Source: Bloomberg

12-mth Price Performance



Source: Bloomberg

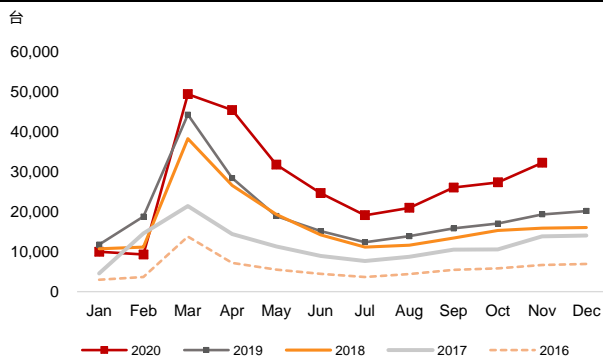
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1. Jiangsu Hengli Hydraulic (601100 CH, BUY) – Expect a strong 3Q; Robust demand in Oct;; Raised estimate & TP – 12 Oct 2020
2. Jiangsu Hengli Hydraulic (601100 CH, BUY) – 2Q Net profit +85% YoY; significant margin expansion – 25 Aug 2020
3. China Construction Machinery Sector – Sustainable demand for excavator in 2H20E – 12 Aug 2020

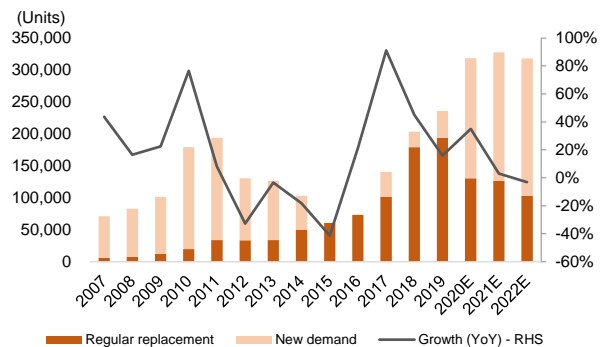
Figure 1: Change in key assumptions

| (RMB mn) | Old | | | New | | | Change | | |
|--|--------------|--------------|--------------|--------------|--------------|--------------|-------------|-------------|--------------|
| | 2020E | 2021E | 2022E | 2020E | 2021E | 2022E | 2020E | 2021E | 2022E |
| Revenue | | | | | | | | | |
| Hydraulic cylinder for excavator | 2,684 | 3,047 | 3,229 | 2,906 | 3,299 | 3,497 | 8.3% | 8.3% | 8.3% |
| Specialised hydraulic cylinder for heavy equipment | 1,650 | 1,876 | 1,947 | 1,650 | 1,876 | 2,040 | 0.0% | 0.0% | 4.8% |
| Hydraulic pump and valve | 1,800 | 2,466 | 3,083 | 1,800 | 2,520 | 3,150 | 0.0% | 2.2% | 2.2% |
| Completed set of equipment | 217 | 250 | 280 | 217 | 250 | 280 | 0.0% | 0.0% | 0.0% |
| Component | 651 | 782 | 860 | 651 | 782 | 899 | 0.0% | 0.0% | 4.5% |
| Revenue (hydraulic business) | 7,003 | 8,421 | 9,399 | 7,225 | 8,727 | 9,866 | 3.2% | 3.6% | 5.0% |
| Other business | 18 | 19 | 21 | 18 | 19 | 21 | 0.0% | 0.0% | 0.0% |
| Total revenue | 7,021 | 8,439 | 9,420 | 7,242 | 8,745 | 9,886 | 3.2% | 3.6% | 5.0% |
| Gross margin | | | | | | | | | |
| Hydraulic cylinder for excavator | 44.3% | 44.0% | 44.0% | 44.7% | 44.7% | 44.5% | 0.4 | 0.7 | 0.5 |
| Specialised hydraulic cylinder for heavy equipment | 41.0% | 41.0% | 41.0% | 41.0% | 41.0% | 41.0% | 0.0 | 0.0 | 0.0 |
| Hydraulic pump and valve | 42.0% | 43.0% | 43.0% | 43.0% | 44.0% | 44.0% | 1.0 | 1.0 | 1.0 |
| Completed set of equipment | 33.0% | 33.0% | 33.0% | 33.0% | 34.0% | 34.0% | 0.0 | 1.0 | 1.0 |
| Component | 32.0% | 33.0% | 33.0% | 32.0% | 33.0% | 33.0% | 0.0 | 0.0 | 0.0 |
| Gross margin (hydraulic business) | 41.4% | 41.7% | 41.7% | 41.9% | 42.3% | 42.3% | 0.5 | 0.7 | 0.6 |
| Other business | 66.0% | 66.0% | 66.0% | 66.0% | 66.0% | 66.0% | 0.0 | 0.0 | 0.0 |
| Average gross margin | 41.5% | 41.7% | 41.8% | 42.0% | 42.4% | 42.3% | 0.5 | 0.7 | 0.6 |
| Net profit | 2,027 | 2,524 | 2,897 | 2,186 | 2,750 | 3,204 | 7.9% | 9.0% | 10.6% |

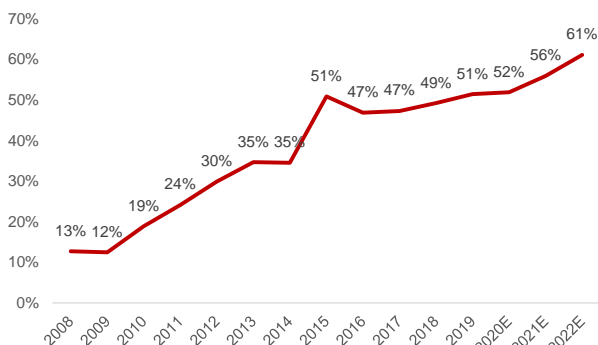
Source: Company data, CMBIS estimates

Figure 2: Excavator monthly sales volume (industry)

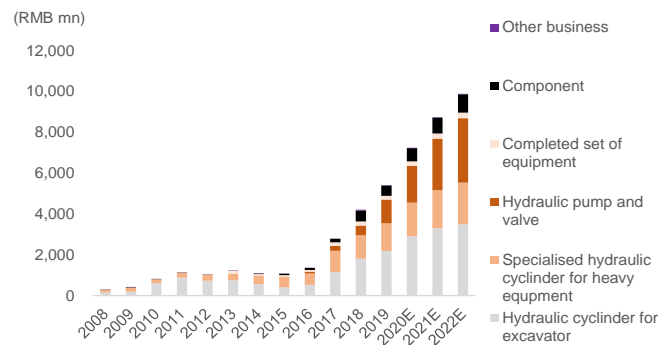
Source: CCMA, CMBIS

Figure 3: CMBIS excavator sales projection (industry)

Source: Company data, CMBIS estimates

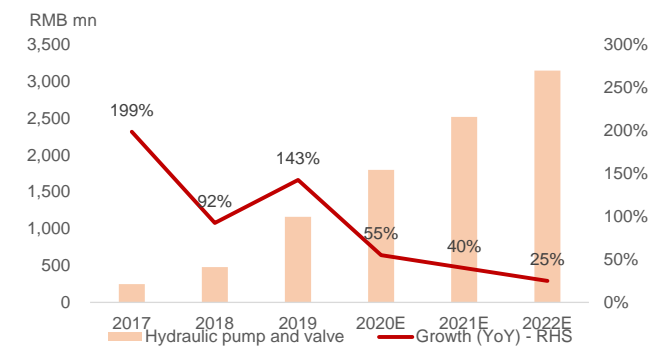
Figure 4: Hengli's market share in hydraulic cylinder for excavator

Source: Company data, CMBIS estimates

Figure 5: Hengli's revenue breakdown

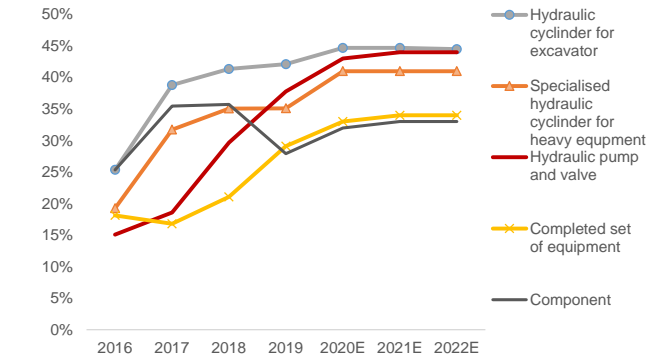
Source: Company data, CMBIS estimates

Figure 6: Hengli's revenue of pump & valves



Source: Company data, CMBIS estimates

Figure 7: Gross margin by segment

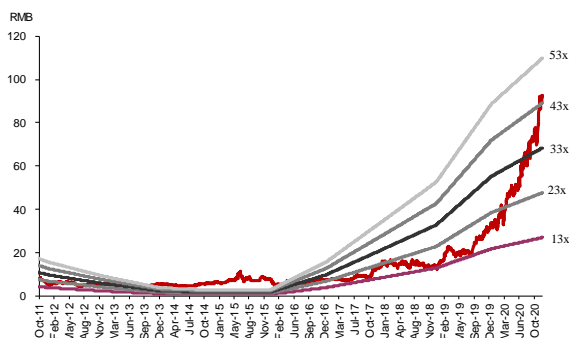


Source: Company data, CMBIS estimates

Valuation

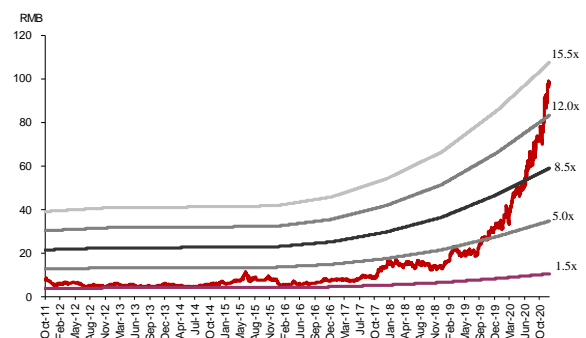
We raise our TP to RMB114.4 from RMB87, based on 55x 2021E P/E (30% premium to the historical average of 42x). We believe the valuation premium is justified due to improving earnings visibility for a couple of reasons: (1) the policy of domestic circulation and competitive landscape are favourable for Hengli to achieve further import substitution across different products; and (2) Hengli's growth has become more structural rather than cyclical.

Figure 8: Hengli's P/E band



Source: Bloomberg, Company data, CMBIS estimates

Figure 9: Hengli's P/B band



Source: Bloomberg, Company data, CMBIS estimates

Financial Summary

Income statement

| YE 31 Dec (RMB mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|-----------------------------|--------------|--------------|--------------|--------------|--------------|
| Total revenue | 4,211 | 5,414 | 7,242 | 8,745 | 9,886 |
| Cost of sales | -2,671 | -3,369 | -4,201 | -5,037 | -5,702 |
| Gross profit | 1,540 | 2,045 | 3,041 | 3,708 | 4,184 |
| Surcharge | -43 | -52 | -72 | -87 | -99 |
| S&D expenses | -115 | -111 | -145 | -166 | -188 |
| Administrative expenses | -385 | -435 | -492 | -560 | -603 |
| Asset impairment | -119 | -52 | 0 | 0 | 0 |
| EBIT | 879 | 1,395 | 2,332 | 2,895 | 3,294 |
| Net finance income/(cost) | 30 | 31 | 158 | 243 | 364 |
| Finance income | 168 | 187 | 210 | 287 | 404 |
| Finance expenses | -138 | -156 | -52 | -44 | -41 |
| Other gains/(losses) | 54 | 67 | 87 | 105 | 119 |
| Profit of JV and associates | 0 | 0 | 0 | 0 | 0 |
| Pretax profit | 963 | 1,493 | 2,577 | 3,242 | 3,776 |
| Income tax | -126 | -195 | -387 | -486 | -566 |
| After tax profit | 837 | 1,298 | 2,190 | 2,756 | 3,210 |
| MI | -0 | -2 | -4 | -6 | -6 |
| Net profit | 837 | 1,296 | 2,186 | 2,750 | 3,204 |
| D&A | 232 | 264 | 293 | 317 | 341 |
| EBITDA | 1,110 | 1,659 | 2,624 | 3,211 | 3,635 |

Cash flow summary

| YE 31 Dec (RMB mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|---|-------------|--------------|--------------|---------------|---------------|
| Pretax profit | 963 | 1,493 | 2,577 | 3,242 | 3,776 |
| Finance cost | -32 | -33 | 52 | 44 | 41 |
| Profit or loss of associates | 0 | 0 | 0 | 0 | 0 |
| Loss/(gain) on disposal PP&E/business | 3 | 1 | 0 | 0 | 0 |
| Depreciation & amortization | 232 | 264 | 293 | 317 | 341 |
| Income tax paid | -337 | -375 | -387 | -486 | -566 |
| Change in working capital | -345 | 66 | -725 | -281 | -482 |
| Others | 332 | 253 | 0 | 0 | 0 |
| Cash flow from operation | 799 | 1,660 | 1,809 | 2,836 | 3,110 |
| Net capex on PP&E | -361 | -434 | -500 | -400 | -400 |
| Investment in JV/associates | 0 | 0 | 0 | 0 | 0 |
| Investment in subsidiaries | -117 | 0 | 0 | 0 | 0 |
| Investment in intangibles | -19 | -4 | -10 | -10 | 0 |
| Dividend received JV/associates | 0 | 0 | 0 | 0 | 0 |
| Others | 216 | -14 | 0 | 0 | 0 |
| Cash flow from investing | -281 | -452 | -510 | -410 | -400 |
| Proceeds from equity financing/(repurchase) | 0 | 0 | 0 | 0 | 0 |
| Net bank borrowings | -8 | -100 | -150 | -150 | 0 |
| Dividend paid | -139 | -265 | -529 | -874 | -1,100 |
| Interest paid | -3 | -107 | -52 | -44 | -41 |
| Others | -1 | 18 | 0 | 0 | 0 |
| Cash flow from financing | -152 | -454 | -731 | -1,069 | -1,141 |
| Change in cash | 366 | 754 | 568 | 1,357 | 1,569 |
| Cash at beginning of the year | 1,146 | 1,571 | 2,343 | 2,912 | 4,269 |
| Exchange and others | 59 | 18 | 0 | 0 | 0 |
| Cash at the end of the year | 1,571 | 2,343 | 2,912 | 4,269 | 5,838 |

Balance sheet

| YE 31 Dec (RMB mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|--------------------------------|--------------|--------------|--------------|--------------|---------------|
| Non-current assets | 2,828 | 2,935 | 3,153 | 3,246 | 3,305 |
| PP&E | 2,233 | 2,364 | 2,583 | 2,678 | 2,748 |
| JV/associates | 0 | 0 | 0 | 0 | 0 |
| Goodwill | 0 | 0 | 0 | 0 | 0 |
| Intangible assets | 279 | 273 | 272 | 270 | 258 |
| AFS investments | 10 | 0 | 0 | 0 | 0 |
| Others | 257 | 257 | 257 | 257 | 257 |
| Deferred tax assets | 49 | 41 | 41 | 41 | 41 |
| Current assets | 4,443 | 5,492 | 7,090 | 8,800 | 11,078 |
| Inventories | 1,050 | 997 | 1,535 | 1,501 | 1,936 |
| Trade and bill receivables | 1,328 | 1,639 | 2,131 | 2,517 | 2,792 |
| Prepayment | 135 | 98 | 98 | 98 | 98 |
| Others | 358 | 414 | 414 | 414 | 414 |
| Pledged deposits | 0 | 0 | 0 | 0 | 0 |
| Cash | 1,571 | 2,343 | 2,912 | 4,269 | 5,838 |
| Current liabilities | 1,981 | 2,170 | 2,375 | 2,346 | 2,574 |
| Trade and bill payables | 691 | 791 | 1,096 | 1,167 | 1,395 |
| Bank borrowings | 905 | 937 | 837 | 737 | 737 |
| Tax payable | 24 | 62 | 62 | 62 | 62 |
| Advance from customers | 154 | 192 | 192 | 192 | 192 |
| Others | 208 | 188 | 188 | 188 | 188 |
| Non-current liabilities | 715 | 643 | 593 | 543 | 543 |
| Bank borrowings | 353 | 200 | 150 | 100 | 100 |
| Deferred tax liabilities | 47 | 70 | 70 | 70 | 70 |
| Deferred income | 165 | 223 | 223 | 223 | 223 |
| Others | 150 | 150 | 150 | 150 | 150 |
| Equity | 4,575 | 5,614 | 7,275 | 9,157 | 11,267 |
| Shareholders' equity | 4,547 | 5,584 | 7,241 | 9,117 | 11,220 |
| MI | 28 | 30 | 35 | 40 | 47 |

Key ratios

| YE 31 Dec | FY18A | FY19A | FY20E | FY21E | FY22E |
|------------------------------------|-------|-------|-------|-------|-------|
| Sales mix (%) | | | | | |
| Cylinder for excavator | 43% | 40% | 40% | 38% | 35% |
| Cylinder for heavy equipment | 27% | 25% | 23% | 21% | 21% |
| Hydraulic pump and valve | 11% | 21% | 25% | 29% | 32% |
| Completed set of equipment | 5% | 3% | 3% | 3% | 3% |
| Component | 13% | 9% | 9% | 9% | 9% |
| Other business | 1% | 0% | 0% | 0% | 0% |
| Total revenue | 100% | 100% | 100% | 100% | 100% |
| Profit & loss ratio (%) | | | | | |
| Gross margin | 36.6 | 37.8 | 42.0 | 42.4 | 42.3 |
| EBIT margin | 20.9 | 25.8 | 32.2 | 33.1 | 33.3 |
| Net profit margin | 19.9 | 24.0 | 30.2 | 31.5 | 32.5 |
| Growth (%) | | | | | |
| Revenue | 50.6 | 28.6 | 33.8 | 20.7 | 13.0 |
| Gross profit | 67.9 | 32.7 | 48.8 | 21.9 | 12.8 |
| EBIT | 90.9 | 58.7 | 67.2 | 24.1 | 13.8 |
| Net profit | 119.1 | 54.9 | 68.6 | 25.8 | 16.5 |
| Balance sheet ratio | | | | | |
| Current ratio (x) | 2.2 | 2.5 | 3.0 | 3.8 | 4.3 |
| Receivable turnover days | 100 | 100 | 95 | 97 | 98 |
| Inventory turnover days | 128 | 111 | 110 | 110 | 110 |
| Payable turnover days | 82 | 80 | 82 | 82 | 82 |
| Net debt / total equity (%) | Net | Net | Net | Net | Net |
| Profitability (%) | | | | | |
| ROA | 12.5 | 16.5 | 23.4 | 24.7 | 24.2 |
| ROE | 19.9 | 25.6 | 34.1 | 33.6 | 31.5 |
| Per share data | | | | | |
| EPS (RMB) | 0.64 | 0.99 | 1.67 | 2.11 | 2.45 |
| BVPS (RMB) | 3.48 | 4.28 | 5.55 | 6.98 | 8.60 |
| DPS (RMB) | 0.20 | 0.41 | 0.67 | 0.84 | 0.98 |

Source: Company data, CMBIS estimates

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