China | Heavy trucks and construction machinery

Weichai Power (2338 HK)

November 7, 2014

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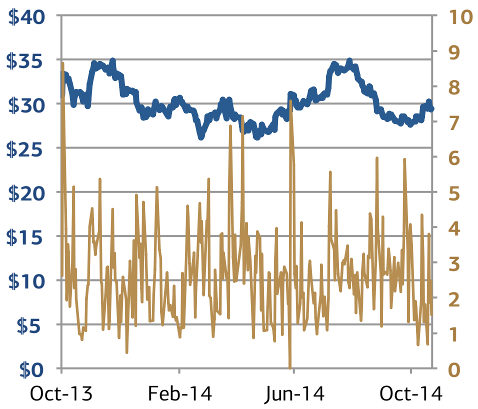
Weichai Power (2338 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, November 7, 2014

Weichar Poiwer (2338 HK)

Price	HKD 29.40
Rating	**SELL**
Price target	**HKD 21.55**
Difference	**-26.7%**
Market Cap	HKD 53.3 bln
Simple Moving Avg.	1.9 mln
P/E	8.83x

Source: Bloomberg, November 7, 2014

Damaged vehicle

+ Still under-provisioning

We previously argued that Weichai was under-provisioning. Weichai has started to recognise higher impairments, but we still think the measures are inadequate. Impairment losses will likely rise.

+ The potential downside

If impairments are as high as we think, Weichai's true NPAT should have shown minimal increase and potentially even declines. We think the market is still under-pricing Weichai's credit risk.

+ Truck industry had a weak Q3

Weichai was able to grow 2014 Q3 NPAT by 10%. This is a remarkable result given that Weichai's main customer, Beijing Daimler Foton Automotive saw its sales crater 25% YoY. Other truck manufacturers such as Cummins expect negative YoY growth for 2014, while KION, Weichai's forklift subsidiary, also saw volumes tail off. Furthermore, NPLs of Shandong banks (Weichai's home province) have increased 44% YTD. This is bound to have negatively impacted the truck eco-system.

+ Where we could be wrong

Weichai is a binary trade. If stimulus works in China's over-leveraged economy, we are wrong. Heavy Duty Truck sales can jump sharply.

+ Valuation

Given a lack of earnings visibility, we think DCF is not an appropriate valuation tool. We use a forward P/E multiple of 9x to value Weichai at HKD 21.55. If a major credit event occurred, it's likely that Weichai's stock price would fall further.

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Keep an eye on impairment losses

The KION accounting entry obscures Weichai's soft underbelly

Weichai's YTD 2014 NPAT was RMB 4.45 bln, up 64% YoY from RMB 2.70 bln in 2013. However, RMB 1.73 bln of 2014 NPAT relates to investment income from the consolidation of KION's accounts – this is a non-cash item.

Removing the KION accounting entry, NPAT would be around RMB 3.11 bln, up 15% YoY.

2014 Q3 NPAT was RMB 680.6 mln, up 10% from 2013 Q3 NPAT. Given that China's Heavy Duty Truck (HDT) sales have been negative YoY, the ability of Weichai to grow NPAT is commendable. Moreover, Weichai's key client, Beijing Foton Daimler Automotive ("BFDA") saw sales crater 25% in Q3. It's remarkable that Weichai was able to grow NPAT in the face of such customer declines. We are not sure how Weichai did it.

We think Weichai has yet to be hit by a large credit cycle and has only just started to recognize impairments. We think Weichai is still under-provisioning and that, if impairments hit previous highs, Weichai would actually have NPAT declines.

Accounts receivable continue increasing

Still under-provisioning

In our initiation report, we noted that Weichai was likely under-provisioning and, while the 3Q numbers show higher impairments, we think Weichai is still under-provisioning.

In 2014 H1, Weichai's bad debts as a % of gross accounts receivable was only 6.9% (Table 2**)**, vs. an average of 13.9% from FY 2010-2013. The almost tripling of accounts receivable since FY 2013 was the main reason that bad debt provisions were lower vs. history.

In 2014 Q3, Weichai's impairment loss on assets in the P&L jumped 64% YoY to RMB 0.46 bln. Weichai attributed this to the "*larger growth of the balance of accounts receivable compared with the corresponding period, hence the increase in provision for bad debts.*"

On a QoQ basis, impairment losses went up sharply by 67% to RMB 0.18 bln.

Weichai stated that the large accounts receivable jump was due to

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"the settlement of accounts receivable from customers of auxiliary products who generally pay according to credit period and tend to settle at year end, and the consolidation of KION..."

Estimating Weichai's bad debts

Are Weichai's bad debts double FY 2013?

Weichai doesn't disclose its Q3 provision for bad debts. We have estimated them to be RMB 1.63 bln, or more than double FY 2013's RMB 0.73 bln.

The average impairment loss as a % of provision for bad debts from FY 2010-2013 was 28.1%. Dividing the 2014 Q3 impairment loss on assets of RMB 0.46 bln by 28.1% results in our estimated RMB 1.63 bln provision.

Assuming RMB 1.63 bln of bad debt provisions, Weichai's bad debts as a % of gross accounts receivable would be 10.9%. This is still low vs. the historical average of 13.9% from FY 2010-2013.

Impairment losses as a % of accounts receivable are also low at 3.5% - FY 2013 was 5.2%, while FY 2010 was 11%.

Table 1. Bad debts increasing with higher accounts receivable

RMB bln	FY 2010	FY 2011	FY 2012	FY 2013	2014 H1	2014 Q3
a) Gross accounts receivable	5.36	5.45	4.84	5.17	13.38	14.84
b) Provision for bad debt	0.78	0.71	0.67	0.73	0.92	1.63*
c) Net Acc/Rec (a-b)	4.58	4.74	4.17	4.44	12.46	13.22
d) Impairment loss on assets (from P&L)	0.51	0.02	0.08	0.23	0.27	0.46

Source: Company financials, J Capital Research

* We estimate RMB 1.63 bln of bad debt provisions for 2014 Q3. This is calculated by dividing "impairment loss on assets" of RMB 0.46 bln by the average "Impairmeent loss % provisionf for bad debts" from FY 2010-2013.

Table 2. Bad debt ratios

%	FY 2010	FY 2011	FY 2012	FY 2013	2014 H1	2014 Q3
Impairment loss % revenue	0.8%	0.0%	0.2%	0.4%	0.8%	0.8%
Impair. loss % prov for bad debt (d/b)*	64.6%	2.6%	11.8%	31.7%	29.6%	28.1%

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Bad debts % Acc/Rec (b/a)	14.6%	13.1%	13.9%	14.1%	6.9%	10.9%
Impairment loss % Acc/Rec (d/a)	11.0%	0.4%	1.9%	5.2%	2.2%	3.5%

Source: Company financials, J Capital Research.

* Table 2 should be read in conjunction with Table 1.

Shaanxi Heavy's bad debts are higher

The domestic filings of Weichai's key HDT subsidiary, Shaanxi Heavy Duty Motor ("Shanqi"), also suggest Weichai is under-provisioning.

Shanqi's impairment losses are double Weichai's

Shanqi's impairment losses as a % of accounts receivable were 5.8%. This is 1.7x Weichai's ratio. In addition, Shanqi's impairment losses as a % of revenue are 1.6%, double that of Weichai at 0.8%.

Notes receivable remain high, though down from 2014 H1

BANs are still high

Weichai's notes receivable, which are bank acceptance notes ("BANs"), remain high at RMB 14.4 bln, in-line with FY 2013's RMB 14.1 bln, but down 19% from 2014 H1. The still high level of BANs means that credit risk remains elevated, particularly due to the incestuous guarantees provided by Weichai and its subsidiaries when accepting BAN payment.

The fall in BANs is not surprising: in a recent Macro report we detailed how banks are becoming more reluctant to issue BANs for the following reasons:

1) Caution on credit against industrial companies.

2) Regulatory changes: banks are now banned from removing BANs from their balance sheets when they repo them out for cash. Keeping BANs on balance sheet increases their capital cost. Therefore banks are less keen to issue them.

3) Shandong banks are also seeing greater stress vs. the rest of China, which would also limit notes receivable financing (see below).

Accounts receivable rise as truckers use their own balance sheet to finance sales

As a result, truck manufacturers are resorting to their own balance sheets to fund customer sales. Accounts receivable across the industry have thus increased.

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Shandong banks having default issues

As noted by the Wall Street Journal,[1] stress in Shandong's banking system appears worse than elsewhere. Shandong is Weichai's home province and it's highly likely that a lot of the banks supporting Weichai with notes receivable and lending facilities are from Shandong.

The WSJ notes that "Credit in Shandong contracted in the third quarter, even as it continued to grow nationally..." and that "such contractions are likely extremely rare, particularly for the major provinces."

Shandong bank NPLs are 1.78%

The WSJ also noted that NPLs were 1.78% in Shandong banks, significantly higher than the 1.08% level across China as a whole. **Total bad loans have increased 44% YTD**, with Q3 showing a rapid increase.

As Weichai is a large SOE, it is unlikely that it would have reduced bank support. However there are likely to be negative impacts on companies in the truck eco-system and this potentially could result in higher impairments at Weichai.

The potential downside from higher impairments

If impairment losses increase, Weichai could have NPAT declines

We think Weichai's impairment losses will increase sharply, and if they are as large as we think, Weichai would have minimal NPAT increase and potentially even declines. This is not reflected in consensus earnings estimates. The RMB 1.73 bln KION investment income also distracts the market from focusing on the underlying credit cycle.

We have modeled different impairment loss scenarios to test Weichai's sensitivity to rising bad debts. The YTD 2014 Q3 NPAT figures in the table do not include the RMB 1.73 bln KION investment income.

- If impairment losses were to double, YTD 2014 Q3 NPAT would have been RMB 2.8 bln and YoY NPAT growth would have been 2%.

- If impairment losses were to triple to 10.4% of accounts receivable or RMB 1.37 bln, YoY NPAT growth would be negative 11%. A tripling of bad debts sounds extreme, but in FY2010, Weichai's bad debts were 11% of accounts receivable.

[1] http://online.wsj.com/articles/china-textile-maker-cancels-pakistan-acquisition-deal-as-local-banks-wont-lend-1415192513

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Table 3. Potential impairment losses

Impairment loss sensitivity	Impairment loss (RMB bln)	Impairment loss % AR	YTD 2014 Q3 NPAT * (RMB bln)	% YoY growth vs 2013 3Q
As reported	0.46	3.5%	3.1	15.0%
Double	0.91	6.9%	2.8	2.0%
Triple	1.37	10.4%	2.4	-11.0%

Source: Company financials, J Capital Research

* YTD 2014 3Q NPAT does not include RMB 1.73 bln investment income from the KION consolidation.

Listed company Q3 results: demand is down

Lower truck demand across the industry

The results of Beijing Foton Daimler Automotive ("BFDA"), Cummins and KION all show that truck and engine demand is trending down.

Weichai's engine sales hit – BFDA down 25% YoY

BFDA is Weichai's key HDT engine customer and is a 50/50 JV between Beiqi Foton Motor and Daimler AG. BFDA produces Auman-branded medium and heavy-duty trucks. In 2013, BFDA accounted for RMB 6.7 bln or 12% of Weichai's total sales.

BFDA's sales cratered in 2014 Q3, falling 25% YoY and 42% QoQ. As Weichai supplies the majority of BFDA's engines, Weichai's engine business likely saw a 20-25% YoY sales fall.

Daimler observed that in 2014 Q3:

"Little dynamism was to be observed in China, the world's biggest truck market, where ***demand was significant lower than in the third quarter of last year****."*

Daimler also noted that:

"In China, the repeated postponement of the introduction of new emission regulations is creating uncertainty and hindering the market's development. Demand in China in 2014 is likely to be slightly below the level of 2013."

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Table 4. BFDA sales down 25% YoY, 42% QoQ

	Sales volume (units)	YoY growth
2012 Q3	13,942	
2012 Q4	17,430	
2013 Q1	23,001	
2013 Q2	28,229	
2013 Q3	24,129	73%
2013 Q4	27,939	60%
2014 Q1	26,643	16%
2014 Q2	31,242	11%
2014 Q3	18,051	-25%

Source: Daimler financials, J Capital Research

Cummins forecasts HDT truck sales to fall 5%

In its Q3 update, US truck manufacturer Cummins forecast 2014 Chinese HDT sales to fall 5%.

KION Q3 results: YTD growth of 14.6%, though Q3 was lower

KION's Q3 volume growth at 8.9% YoY tailed off from the very strong start to 2014 (2014 H1 volume growth was 17.5%). YTD volume growth was still strong at 14.6% YoY.

KION attributed growth trending down to a "…slight decline in the volume of diesel trucks."

Weichai supplies engines for KION's Baoli forklifts. It is interesting that volume growth has dropped given market expectations for strong forklift demand from e-commerce and logistics.

Why the margin loans?

Are SOEs being encouraged to punt on A-shares?

We have noticed that two of Weichai's largest shareholders have pledged Weichai A-shares as collateral for margin loans.

- Shandong Enterprise Trust Operation Company Ltd owns 1.34% of Weichai's shares and has pledged all of these shares as collateral for a margin loan with China Securities Co., Ltd.

- Zhuzhou State-owned Assets Investment Holding Group Company Ltd ("Zhuzhou") owns 0.60% of Weichai's shares. Zhuzhou first pledged Weichai shares for a margin loan in FY 2013, and now has pledged 99% of its shares for a margin loan with Guotai Junan Securities Company Ltd.

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- We don't know why these 2 companies have pledged Weichai shares as margin loans—they could be lacking cash, or simply speculating on Weichai's stock price. The combined holding of their shares is less than 2%, so is not significant. However it's something to watch, particularly if Weichai's stock price was to gap down in a quick time, as this could trigger margin calls for these shareholders.

- As part of the broader macro picture, it also suggests that SOEs are being encouraged to invest in A-shares to drive the A-share market higher.

Where we could be wrong

Weichai is a binary trade

Weichai is a binary trade, so if we're wrong on stimulus, then we're wrong on Weichai. If the recent mini-stimulus has a positive effect on the Chinese economy and FAI growth rebounds, Weichai will benefit. Any positive stimulus could see HDT sales spike up by 20%.

At the start of 2014, Weichai bulls argued that replacement demand would propel HDT sales to YoY growth. This has not eventuated. The new tune is that replacement demand will occur in 2015, plus sales will benefit from China's mini-stimulus.

Using macro reasons to underpin an investment thesis for Weichai is risky. The reality is that consensus estimates remain overly optimistic and assume straight-line earnings growth. As shown in our initiation report, **Weichai's past earnings have been very volatile. Moreover future earnings visibility is quite low and hard to forecast**.

Recall that Weichai's EPS growth was down 17.4% in FY 2011, down 55.4% in FY 2012 and up 19.3% in FY 2013. It's overly optimistic to forecast robust CAGR earnings growth over the next 2-3 years in the face of China's slowing economy.

Valuation

We retain our existing price target of HKD 21.55.

Weichai's average historical P/E has been 12x and Weichai is currently trading below this at 8.7x FY 2013 consensus earnings and 9.9x 2014F consensus earnings.

Therefore at first glance Weichai doesn't appear to be way overvalued. As recently as January 2013, it was trading at 20x P/E.

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Weichai has traded at 6.5x P/E in August 2011 and as low as 2.8x in November 2008. So there is large potential for Weichai to fall. We think the current 9x P/E based on consensus is a value trap and doesn't factor in Weichai's risks.

Given our concerns over Weichai's credit risk and the negative industry outlook, we think a 9x forward P/E multiple is appropriate. Our forecast of 2014F EPS of RMB 1.90 yields a price target of HKD 21.55, or 27% downside as of November 6, 2014.

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