



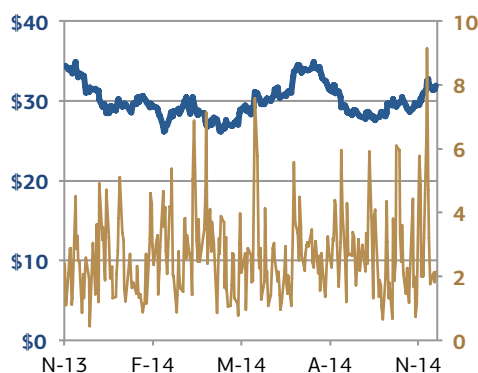
December 19, 2014

China | Heavy trucks and construction machinery

Weichai Power (2338 HK)

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



Source: Bloomberg December 19, 2014

Weichai Power (2338 HK)

Price	HKD 31.90
Rating	SELL
Price target	HKD 21.55
Difference	32%
Market Cap	HKD 65.7 bln
Simple Moving Avg.	3.47 mln
P/E	9.74x
Float	100%

Source: Bloomberg December 19, 2014



The false hope rally

+ Westport is not a bright spot

Weichai's stock price rallied on news that it had increased its sales cap with Weichai Westport ("Westport"), a related party. On closer examination of the disclosure, we think the market overreacted on pretty flimsy news.

+ Westport's sales have increased, but profits are down 32% YoY due to price cuts

While Westport's sales are up 16% YoY, net income has actually fallen 32% YoY. The sales increase has been driven by price cuts.

+ Natural gas vehicles are not the saviour

We spoke with various people in the natural gas engine sector. They said fierce competition has been driving price cuts, and overall industry sales are down vs 2013. The fall in the oil price has also made natural gas less attractive.

+ Valuation

The recent rally in Weichai's stock price due to this related party transaction is an opportunity to re-establish shorts. We retain our existing price target of HKD 21.55.

Natural gas is not the savior

Weichai's stock price rallied on news of an increase in sales and purchase caps with a related party

On December 8, Weichai announced a continuing connected transaction with Weichai Westport ("Westport"), Weichai's 40%-owned natural gas vehicle subsidiary. Weichai has increased the cap on how much it sells to Westport (a related party) and how much it then buys back from Westport.

Weichai's stock price on December 9 reacted very positively to the announcement and at one stage was up 7% intra-day. Weichai finished the day up 3%.

On closer examination of the disclosure we think the market overreacted on pretty flimsy news. Despite being in the "trendy" sector of natural gas vehicles, **Westport is actually not a bright spot among Weichai's many subsidiaries.**

Sales and purchase caps with a related party

Westport is a JV between Weichai (40% owner), Westport Innovations (35%), and Petersen (CNG) Equipment Limited (25%). Westport produces natural gas engines.

- **Sales:** Weichai sells base engines and gas engine parts to Westport.
- **Purchase:** Weichai also buys natural gas engines and parts from Westport.
- Sales and purchases are subject to agreed caps.
- Weichai exceeded the sales and purchase caps in FY 2012, most likely as it was the initial year. However only hit 68-69% of the sales and purchase caps in FY 2013.
- For FY 2014, Weichai is unlikely to hit the RMB 2.8 bln sales cap or 3.4 bln purchase cap.

However, Weichai hasn't been achieving existing sales caps

Table 1. Actual transactions haven't hit caps for the last 2 years

RMB mln	FY2012	FY2013	YTD 2014
Sales cap	200	2,100	2,800
Actual sales	866	1,426	1,680
Actual sales % of cap	433%	68%	60%
Purchase cap	400	4,200	5,500
Actual purchases	1,663	2,907	3,414
Actual purchases % cap	416%	69%	62%

Source: Westport Innovatiions, J Capital Research

Another bureaucratic target to meet

Increasing the caps

Weichai's stock price rallied because of a large increase in the sales and purchase caps. FY2015's sales cap is RMB 3.1bln, up 11% from FY 2014. FY2016-FY2017 shows similar YoY growth.

Purchases however, actually had a drop in cap, down 4% to RMB 5.3bln in FY2015.

Table 2. New transaction caps

RMB mln	FY2015	FY2016	FY2017
Sales cap	3,100	3,500	3,900
Purchase cap	5,300	5,600	6,000

Source: Westport Innovatiions financials, J Capital Research

How material?

This is the key question. While the increase in sales cap appears large, the reality is that over the last two years, Weichai has only sold around 70% of the total sales cap. So it's hard to be certain that future year sales will hit the new caps.

Price cuts to drive sales: Squeezed margins

Despite higher sales, net income cratered 32% YoY

Westport Innovations provides some disclosure on how profitable its JV with Weichai really is. In short, despite higher unit sales, which are up 16% YoY for YTD 2015, **net income has actually fallen 32% YoY.**

Westport's YTD unit sales are 34,830, up 16% from 30,019 in the first three quarters of 2013. However, product revenue is only up 14% YoY, due to ASP falling 2% YoY to RMB 12.2k.

Cost of product increased more than revenue, up 16% YoY. A natural gas vehicle engineer told us that a lot of parts are imported and the cost is relatively higher.

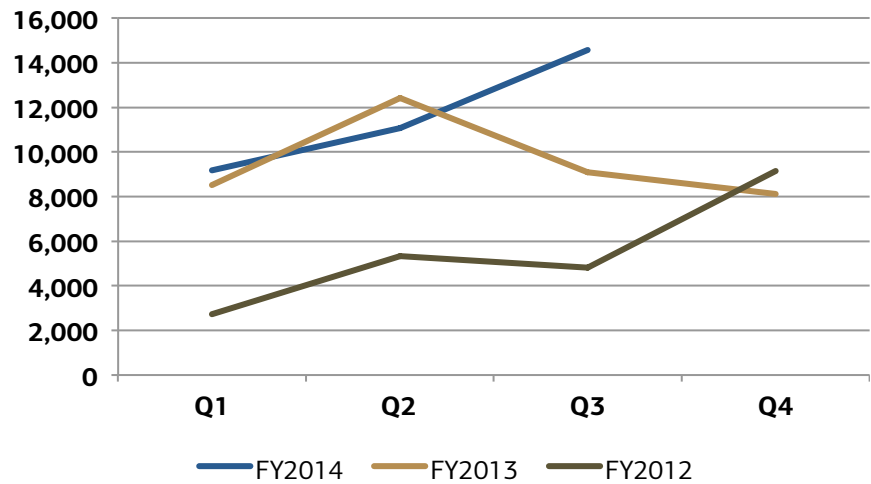
In short, Westport has been driving higher sales through price cuts. **Therefore, although Westport's sales cap has been increased, there may not be any material increase in equity income to Weichai as margins have been falling.**

Table 3. Westport: lower ASPs, higher costs

RMB	2012	2013	2014
Product revenue	164,685,000	372,977,000	425,690,000
Cost of product	144,387,000	345,204,000	401,693,000
Unit sales	12,884	30,019	34,830
ASP	12,782	12,425	12,222
Avg. cost of product	11,207	11,500	11,533

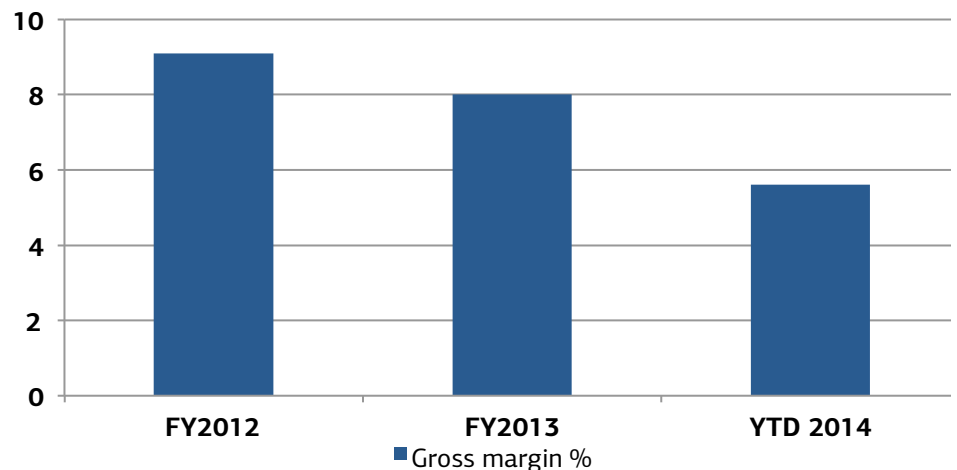
Source: Westport Innovations financials, J Capital Research

Chart 1. Unit sales have been increasing



Source: Westport Innovations financials, J Capital Research

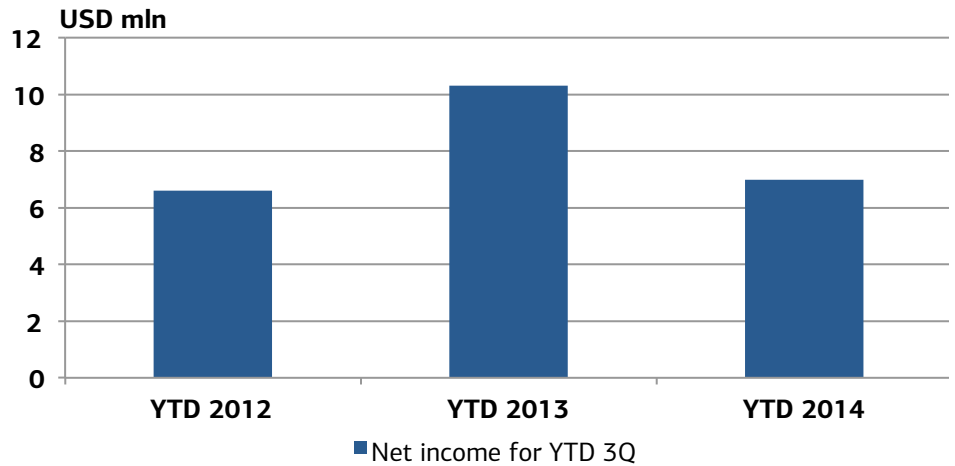
Chart 2. But gross margins have been falling



Source: Westport Innovations financials, J Capital Research

Gross margins have fallen considerably since FY2012

Chart 3. Net income down 32% YoY



Fierce competition has been driving price cuts

Source: Westport Innovations financials, J Capital Research

Interviews

We spoke to various people in the natural gas engine sector to understand underlying demand, Westport’s positioning and industry competition.

The key take-out is that fierce competition has been driving price cuts, and overall industry sales are down vs 2013.

- **Weichai has a strong brand:** Weichai is considered one of the strongest players in natural gas engines, along with Yuchai and SAIC. Weichai’s brand recognition is high. Weichai doesn’t only supply its subsidiary Shaanxi Heavy, but also supplies FAW and JAC.
- **Growth:** Growth is expected in natural gas vehicle demand, particularly for trucks, but volumes are not large at the moment.
- **Fierce competition driving price cuts:** A number of interviewees, including Westport competitors said that competition is very fierce. There are a lot of manufacturers playing in the space and this is a major reason for price cuts.
- **Industry sales down:** Overall industry sales in 2014 were not as good as last year. One interviewee thought next year would be about the same.
- **Oil price fall negative:** Lower oil prices will negatively impact natural gas vehicle demand because petrol prices will have fallen. A key reason to use natural gas is that it’s cheaper than petroleum.

A lower oil price is negative for natural gas vehicle demand

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- **More expensive purchase price:** Natural gas engines are around RMB 10-30,000 more expensive than diesel trucks. However actual usage is more economical because of cheaper fuel costs.
 - **Natural gas infrastructure:** Infrastructure is better in areas rich with natural gas resources.

No solid reason for the recent rally

Continue to short Weichai

The recent rally in Weichai's stock price due to this related party transaction is an opportunity to re-establish shorts in Weichai.

The Westport JV is not a bright spot for Weichai and is actually seeing lower profits. We are skeptical whether the new sales caps will even be achieved. Even if they are, falling margins mean this industry is not a savior for Weichai.

We retain our existing price target of HKD 21.55

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