

Kunming Machine Tool



Tools of survival

Not Rated

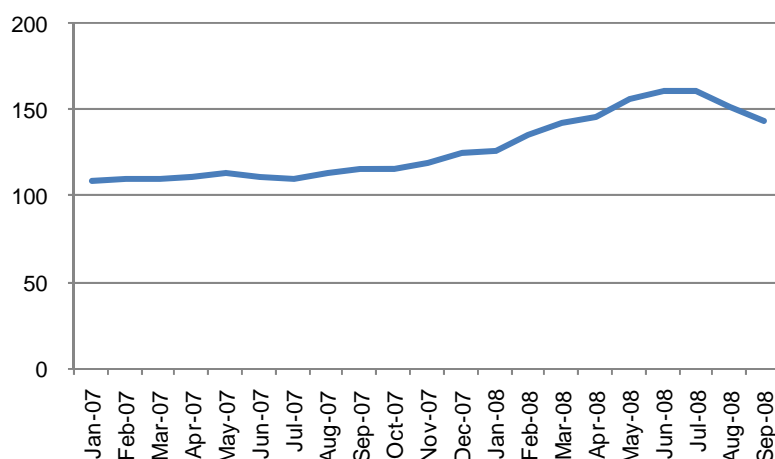
Investment theme. Kunming Machine Tool (KMT) is China's leading machine tool supplier, specializing in mid and large boring and milling machines. We consider the machine tool industry as a cyclical sector, heavily affected by macro factors. Our basic investment theme towards this sector during an economic downturn is to accumulate only when either the recovery is on the horizon or the valuation of a particular stock reaches a certain low level.

Weakening demand. Despite the government's RMB4.0tr stimulus package, we expect demand for machine tools to weaken as entrepreneurs turn cautious in their capital investment amid the slowing economy. We expect the effects of the stimulus package to be limited to the construction and related sectors, especially at the initial stage.

Expansion postponed. KMT's orders in hand will occupy all its production capacity till mid-2009. However, the company has decided to postpone its expansion as a decline in demand for small machines is becoming more pronounced, signaling market contraction.

Gross margin. China's steel price composite index rose 32.3% on average during Jan-Sep 2008. Although the steel price has been softening since July, after the general retreat of commodity prices globally, the average price in 3Q was still 35.1% higher YoY. Because of the delayed effect of steel price hikes due to inventory, we expect KMT's gross margin to come under pressure in 2H, which may last into 2009, based on the current trend.

Chart 1: Steel price composite index



Source: China Iron & Steel Association

China Industrials

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Norman Zhang

(852) 2533 3715

normanzhang@sbie2capital.com

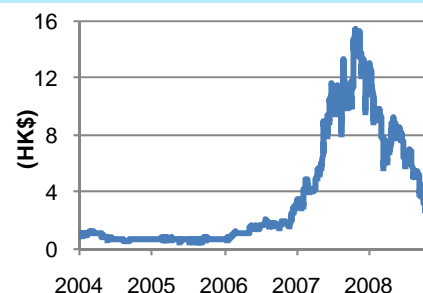
Stock data

Price	HK\$2.85
Target price	n.a.
12 mth range	HK\$1.59-16.00
Market cap.	US\$327.2m
Daily t/o, 3 mth	US\$0.3m
Free float %	26.3%
Ticker	0300.HK/300 HK

Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (RMBm)	818.1	1,266.7			
Net profit (RMBm)	102.5	241.5			
EPS (RMB)	0.241	0.568			
EPS Δ %		135.7			
P/E (x)	10.5	4.4			
P/B (x)	1.71	1.23			
EV/EBITDA (x)	13.6	6.2			
Yield (%)	-	-			
ROE (%)	16.3	32.3			
ROCE (%)	19.1	36.4			
N. Gear. (%)	Cash	Cash			

Price Chart



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1H FY12/08A results. Turnover increased 46.2% to RMB791.7m, comprising RMB674.1m (up 51.7%) from boring machines, RMB5.9m (up 203.2%) from sensors and turbo tables and computerized embroidery machines, RMB2.6m (up 22.6%) from intelligent electrical appliances and RMB118.9m (up 23.6%) from turbo machines. KMT's gross margin widened 2.3pcp to 34.0%, thanks to sales mix changes. Net profit increased 55.7% to RMB147.9m.

Outlook.

- Top line to stay flat HoH in 2H FY12/08F due to capacity constraints and gross margin to shrink due to the high steel price.
- 1H FY12/09 performance in secure thanks to the current order book. In 2H, top line may be adversely affected by the economic slowdown, while the gross margin should improve gradually as the steel price softens.
- With net RMB334.7m cash at end-June, the company's balance sheet is healthy. With piled up inventories during the downturn to consume spare capacity, working capital will increase accordingly.

Valuation. The counter's P/E band ranges from 2.9x to 82.1x. It is currently trading at 4.5x, historically.

Table 1: P&L

Year to Dec (RMBm)	06A	07A	08F	09F	10F	1H 07A	1H 08A
Continuing operations							
Turnover	818.1	1,266.7	1,642.7	1,692.3	1,983.0	541.7	791.7
Cost of sales	(571.9)	(830.9)				(369.9)	(522.5)
Gross profit	246.2	435.8				171.8	269.2
Other revenue	33.1	55.0				27.4	46.5
Other net income / (expenses)	(1.5)	25.7					
Selling expenses	(39.8)	(61.7)				(25.9)	(36.7)
Administrative expenses	(97.0)	(147.2)				(51.7)	(97.7)
Other operating expenses	(1.3)	(10.1)				(1.6)	(3.3)
Profit from operations	139.8	297.5				120.0	177.9
Finance costs	(6.2)	(3.1)				(2.3)	(1.8)
Share of profits of associate		0.0				(0.2)	(0.6)
Share of profits of jointly controlled entity	1.5	5.0				1.0	3.8
Profit before taxation	135.1	299.4				118.5	179.4
Income tax	(16.7)	(47.2)				(13.4)	(25.9)
Profit from continuing operations	118.4	252.1				105.2	153.4
Discontinued operation							
Loss from discontinued operation	(6.6)	(2.0)				(2.0)	
Profit for the period	111.8	250.1				103.2	153.4
Attributable to:							
Equity holders of the Company	102.5	241.5	267.7	277.3	316.5	95.0	147.9
Minority interests	9.3	8.7				8.2	5.5
EPS - Basic (RMB)	0.241	0.568	0.623	0.663	0.745	0.224	0.348
EPS - Diluted (RMB)	0.251	0.572				0.227	0.348

Source: Company data, Bloomberg