

## DH Wuling Automobile Holdings Ltd.

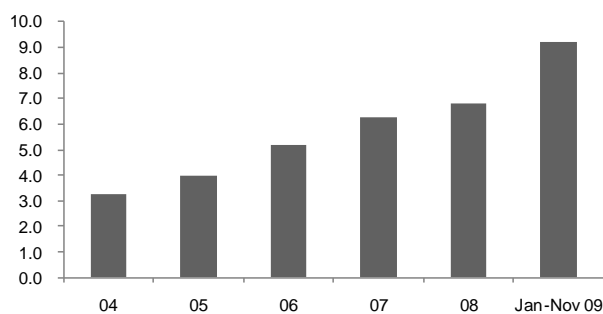
### Get the show on the road

#### to summarize...

- Sustainable automobile market in 2010 after extension of favourable policies.
- 31.0% top-line growth in 1H backed by SGMW's 49.2% increase in car sales and DHWL's own 87.8% jump in specialized vehicle segment.
- Capacity shortage dragged down gross margin by 0.8pcp to 6.2% in 1H but improvement is expected following Qingdao plant's scaling up.
- Impressive progress achieved in specialized vehicle division by exporting 100 electric cars to America and getting one model chosen by the government.
- Extra funding is needed to meet capital contribution commitment to the JV and, thereafter, will be used for capacity expansion.
- Earnings to hit RMB118.1m in FY12/10F and RMB183.8m in FY12/11F.
- Fair value estimated at HK\$1,341.2m, containing 25.0% valuation discount to peers.

**Policy-driven market prosperity.** Multiple measures were launched last year to support development of automotive industry, especially for small cars, including lowering purchase tax from 10.0% to 5.0% (vehicles $\leq$ 1.6l) and offering direct subsidy to rural consumers (truck $\leq$ 6,000kg, passenger car $\leq$ 1.3l). These measures not only effectively brought down overall purchase cost but also push the demand by heating up consumption sentiment. In Jan-Nov, entire automobile sales jumped 42.4% to 12.2m units, which was 3.6m more than the same period last year. Sales of passenger car surged 49.6% to 9.2m units during the period or 98.2% in the single Nov to 1.0m units. Small passenger car ( $\leq$ 1.6l), meanwhile, is absolutely the market's star and contributed 85% (~3.1m units) of the incremental 3.6m.

Chart 1. Passenger car sales in China (units m)



Source: CAAM

**Steady market going forward in expectation.** The Chinese government announced to extend those favorable measures to 2010. Thereafter, we expect a series of fine-tune, instead of a one-off adjustment, to gradually bring policies back to normal, because:

- We believe it is the government's intention to keep the market steady given automotive industry's important position in economy and employment;
- The dramatic growth in 2009 showed apparent policy influence on the automobile market or, in other words, the market is "controllable".
- Financial wise, despite the tax rate cut, the State Administration of Taxation recorded 12.0% increase in automobile consumption tax in Jan-Oct and 6.3% in purchase tax.

According to our channel check, most automobile manufacturers are looking for

Ticker	0305 HK
Rating	Not Rated
Price (HK\$)	1.13
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.37-1.47
Market cap. (US\$m)	132.9
Daily t/o (US\$m)	0.2
Free float (%)	28.9

#### Financial summary

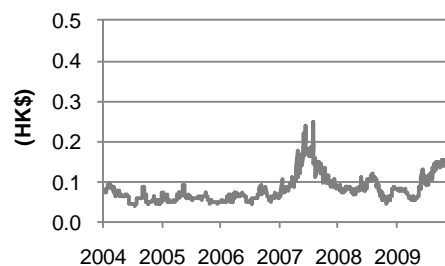
Year to Dec	07A	08A	09F	10F	11F
Turnover (RMBm)	2,856	7,112	9,633	11,656	12,624
Net Profit (RMBm)	11.1	32.6	(28.0)	70.0	97.7
EPS (RMB)	0.013	0.036	(0.030)	0.076	0.107
P/E (x)	79.4	28.1	(32.8)	13.1	9.4
P/B (x)	1.22	6.25	7.72	4.86	3.20
EV/EBITDA (x)	4.4	1.9	1.4	1.0	0.8
Yield (%)	1.2	0.0	0.0	0.0	0.0
ROE (%)	20.5	25.6	(21.1)	45.5	41.1
ROCE (%)	28.3	22.7	17.4	33.8	32.8
N. Gear. (%)	cash	cash	cash	cash	cash

Source: SBI/Bloomberg

	09F	10F	11F
Consensus EPS (RMB)	n.a.	n.a.	n.a.
Previous earnings (RMBm)	74.8	104.0	111.4
Previous EPS (RMB)	0.082	0.113	0.121

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	-10.1	26.8	117.3
Actual price changes (%)	-10.3	32.9	117.3



Source: Bloomberg

#### Research Team

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double-digit growth this year. For the next year, we expect the overall market to stay steadily.

**Table 1. Summary of governmental policies towards automotive consumption**

	09	10
Purchase tax	▪ 5.0% for small cars ( $\leq 1.6l$ ),	▪ 7.5% for small cars ( $\leq 1.6l$ ),
Subsidy	▪ 10% of selling price with maximum of RMB5,000 for small trucks	▪ 10% of selling price with maximum of RMB5,000 for small trucks
	▪ 10% of selling price with maximum of RMB5,000 for small passenger cars	▪ 10% of selling price with maximum of RMB5,000 for small passenger cars
	▪ 13% of selling price with maximum of RMB650 for motorcycle	▪ 13% of selling price with maximum of RMB650 for motorcycle
	▪ 10% of selling price for replacement purchase with maximum of RMB5,000	▪ 10% of selling price for replacement purchase with maximum of RMB5,000-18,000

Source: compiled by SBI E2-Capital

**31.0% top-line growth in 1H.** DHWL posted 31.0% top-line growth in 1H FY12/09A to RMB4,813.9b, comprising RMB2,508.5m from components and accessories division, RMB1,622.4m from engines and parts division, RMB490.5m from specialized vehicle division and remaining balance from trading and others.

- Components and accessories – Segmental revenue surged 51.8% backed by the fact that SAIC-GM-Wuling (SGMW, 上汽通用五菱) sold 525,050 cars in 1H 09, which was 49.2% higher than the same period last year. DHWL, through a 51.0% subsidiary Wuling Industrial (WLI), is a sole key supplier of SGMW (~95% of demand).
- Engines and parts – SGMW is building up its own engine production capacity, used mainly for new car models, which obviously affected DHWL, though ~60% engines still come from the latter. Segmental revenue enlarged 9.0% only in 1H.
- Specialized vehicle – Products include refitting cars (e.g. mini fire truck, minibus, ambulance, etc) and tourism cars. Leveraged by its expertise in whole car, engine and components, DHWL has been growing rapidly in this specific area. Segmental revenue nearly doubled in 1H from RMB261.2m to RMB490.5m.

Gross margin, however, narrowed by 0.8pcp to 6.2%, blaming to: 1) unprecedented demand, which ran out of DHWL's existing capacity (components and accessories), forcing it to outsource part of production; 2) initial loss from the new Qingdao base, including transporting some products from Liuzhou to Qingdao to fulfill SGMW's need locally. Operating profit, therefore, edged up by merely 1.2% to RMB129.5m. The company booked RMB61.4m loss from fair value change of CB (HK\$100m, issued in Jan 08 to LZWL with initial conversion price of HK\$0.74). Thus, bottom line turned red at RMB41.4m from RMB8.4m net profit one year ago.

**Improving gross margin in 2H.** Operation in Qingdao is ramping up quickly. According to the management, gross margin in 3Q recovered to a normal level and we expect this performance to maintain in 4Q given the robust demand. In addition, we expect margin enhancement from specialized vehicle segment after capacity expansion from 20,000 units to 30,000 units. Therefore, blended gross margin in 2H is anticipated at 12.2% (2H FY12/09A: 12.8%).

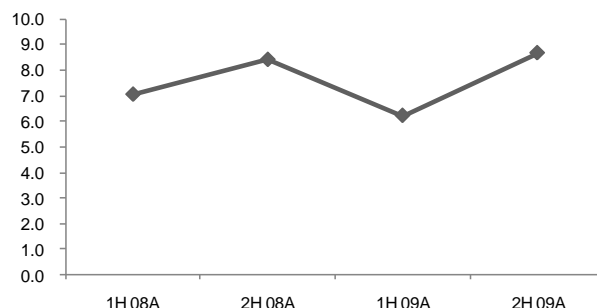
**Encouraging outlook of specialized vehicle division.** In our previous report, we addressed the company's growth drivers include: 1) continuous close cooperation with SGMW; 2) obtaining new clients; 3) margin improvement mainly from enlarging operating scale and more in-house production; 4) development of specialized vehicle business. Although gross margin squeezed in 1H unexpectedly, we maintain our view but revise up expectation on specialized vehicle considering:

- Lacking competition in mini specialized vehicle area – DHWL is one of few sizeable players in the field with sufficient experiences, resources and version.
- Satisfactory result in 1H – ~15,000 cars were sold in 1H, compared with ~20,000 units in full FY12/08A, and, accordingly, segmental revenue surged 87.8%.
- New products roll-out and exploring in overseas market – In Aug, the company exported 100 electric mini trucks to the US. In Dec, DHWL's storage/stake truck (model: LQG5020CSAC06) was chosen as model energy-saving designs for electric and hybrid cars in the fifth batch of list released by the Ministry of Industry and Information Technology.

The management has a sales target of 50,000 units for 2010, which looks feasible. We further anticipate the sales will increase to 70,000 units in 2011, which is higher than our previous assumption of 60,000 units.

**Steady top line growth accompanied by improving margin.** We forecast the company will have RMB42.6m recurrent net profit in FY12/09F (RMB28.0m net loss after including RMB70.6m loss from fair value adjustment on CBs) based on RMB9,632.6m revenue (up 35.4% YoY). Assuming automotive market in China will grow another 10.0% in 2010 and stay flat in 2011, DHWL's top line is expected to increase 21.0% to RMB11,655.8m in FY12/10F and 8.3% to RMB12,624.0m in FY12/11F. The enlarging specialized vehicle division will contribute to gross margin, which is estimated at 11.0% for FY12/10F and 11.6% for FY12/11F, up from 10.3% in FY12/09F. Correspondingly, net profit will reach RMB70.0m in FY12/10F and RMB97.7m in FY12/11F.

**Chart 2. Blended gross margin (%)**

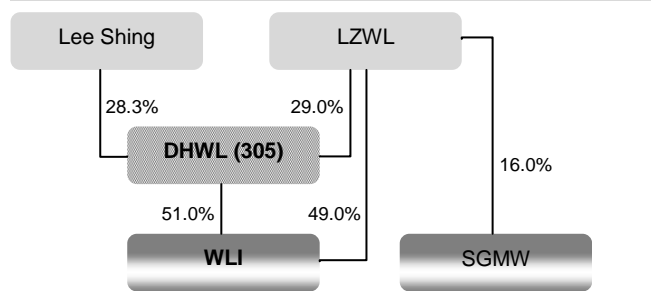


Source: Company data

Note: Gross margin dropped in 1H 08A was mainly due to the commodities price hike during the period. The company normally negotiates prices with suppliers in Jun/Jul

**Extra capital needed for double purposes.** DHWL reached a JV agreement with Liuzhou Wuling (LZWL) in May 07 to convert WLI, a wholly-controlled subsidiary of LZWL then, into a sino-foreign JV. DHWL committed to contribute total RMB392m to the JV in exchange for 51.0% stake holding. RMB78.2m was paid in Aug 07 and another RMB87.9m in Jan 09, leaving an unpaid installment of RMB225.9m. Although there was RMB1,693.2m cash reserve on the company's balance sheet by end-Jun 08, majority of which were owned and controlled by WLI and the listco needs extra fund to pay down the installment.. From the operation level, i.e. WLI, further capacity expansion has been planned with total capex budget at RMB350m.

**Chart 3. Passenger car sales in China (units m)**



Source: Company data

**Table 2. Expansion projects**

Projects	Budget
Raising expansion for components and accessories division	RMB100m
600,000 units of cylinder body for engines and parts division	RMB200m
Expanding specialized vehicle capacity from 30,000 units to 50,000 units	RmB50m
Total	RmB350m

Source: Company data

**One-off earnings enhancement.** After the last round of RMB225.9m capital payment, DHWL's profit sharing in WLI will increase from present 30.6% to 51.0% immediately. Assuming it will be completed by Mar, the listco's net profit will enlarge to RMB118.1m in FY12/10F and RMB183.8m in FY12/11F.

**Table 3. Summary of active coverage in 2009**

Y/F 31 Dec (RMBm)	07A	08A	09F	10F	11F
Revenue	2,856.5	7,111.9	9,632.6	11,655.8	12,624.0
Cost of sales	(2,591.9)	(6,339.7)	(8,638.8)	(10,371.8)	(11,156.3)
Gross profit	264.5	772.2	993.8	1,284.0	1,467.7
Other income	36.5	85.1	81.2	102.5	114.6
Distribution costs	(51.7)	(187.2)	(235.6)	(279.4)	(288.0)
General and administrative expenses	(100.6)	(422.8)	(502.0)	(601.1)	(631.9)
Research and development expenses	(48.5)	(40.3)	(73.8)	(112.6)	(147.2)
Profit from operation	100.1	207.1	263.6	393.4	515.2
Net (loss) gain on held-for-trading investment	9.0	(0.2)	0.0	0.0	0.0
Change in fair value of derivative financial instrument			(70.6)	0.0	0.0
Share of results of an associate	0.2	0.8	0.8	0.9	1.0
Increase in fair value of investment properties	5.2	2.2	0.3	0.0	0.0
Finance costs	(17.2)	(45.0)	(45.0)	(50.9)	(52.2)
Profit before taxation	97.2	164.8	149.2	343.5	464.0
Income tax expenses	(22.6)	(27.9)	(31.4)	(55.4)	(74.3)
Profit for the period	74.6	136.9	117.8	288.0	389.8
Attributable to:					
Equity holders of the Company (30.6% interest)	11.1	32.6	(28.0)	70.0	97.7
Minority interests	63.5	104.2	145.8	218.0	292.1
Equity holders of the Company (51.0% interest after Mar 09)	11.1	32.6	(28.0)	118.1	183.6
Minority interests	63.5	104.2	145.8	170.0	206.2

Source: Company data, SBI E2-Capital

**Peers trading at 13.4x FY12/10F P/E.** The average P/E ratio of auto components and parts group is 16.3x in FY12/09F and 13.4x in FY12/10F. Based on the 13.4x two-year forward P/E and RMB118.1m estimated net profit in FY12/10F, we calculate an initial market value of RMB1,582.5m. Valuation discount is desired, in our view, to compensate additional risks from:

- Uncompleted transaction –additional RMB225.9m cash payment is required to obtain the full 51.0% earnings share.
- Not clear enough ownership – LZWL owns 29.9% interest of DHWL (38.9% after conversion of the CBs) while the old shell holder, Mr. Lee Shing, has 28.3%. Investors might prefer an absolute controlling of LZWL on the listco.

Nevertheless, bearing in mind, the RMB118.1m earnings forecast in FY12/10F contains a natural discount by assuming the final installment will be paid in Mar (RMB134.1m net profit on pro-forma basis). Meanwhile, the listco's mere 51.0% stake ownership in WLI brings expectation on further asset injection. Overall, we pick a discount at 25.0%, which gives a fair value at HK\$1,341.2m for DHWL, versus HK\$1,036.5m market capitalization at the moment.

Table 4. Valuation of peers group

Company	Ticker	Market cap (US\$m)	Historical P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	P/B (x)	ROE (%)
DH Wuling	305 HK	132.9	n.a.	n.a.	n.a.	8.7	25.6
<b>Auto components and parts</b>							
Minth	425 HK	1,506.4	22.7	17.1	14.5	3.0	13.6
Xinyi Glass	868 HK	1,629.8	22.8	16.1	11.9	2.6	16.9
Weichai Power	2338 HK	8,073.8	36.7	15.9	14.0	5.6	26.8
			27.4	16.4	13.4	3.7	19.1
<b>Whole car</b>							
Denway	203 HK	4,887.2	16.5	15.3	13.5	2.5	17.3
Geely Automobile	175 HK	3,871.8	19.3	21.6	17.5	4.8	26.9
Brilliant China	1114 HK	1,457.3	n.a.	n.a.	21.1	1.6	1.3
Dongfeng Motor	489 HK	12,880.0	21.2	15.3	13.5	3.8	20.7
Greatwall Motor	2333 HK	1,315.7	24.6	14.8	11.6	1.3	7.8
			20.4	16.8	15.4	2.8	14.8

Source: Bloomberg

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