

Good Friend: Solid foundation to grow

Recommendation: Not Rated

Hong Kong Industrials

Price	HK\$6.50	Yield (12/06A)	0.7%
12 mth range	HK\$0.63-7.60	ROE (12/06A)	21.9%
Market cap.	US\$280.0m	Net gearing (12/06A)	Net Cash
No. shares o/s	336.0m	Net debt/sh. (12/06A)	Net Cash
Daily t/o, 3 mth	US\$0.14m	BV/sh. (12/06A)	RMB0.88
Free float %	25%	Consensus EPS	
Major shareholder	Good Friend (HK) Corp. Ltd. -75%	- 12/07F	RMB0.28
Ticker	2398.HK/ 2398 HK	- 12/08F	RMB0.48

Key points:

- China's largest foreign-invested producer of CNC machine tools.
- Strong parental support (planned asset injection) and expertise in higher-end precision tools.
- Solid demand for machine tools from China's booming automobile industry.
- Government's increased military, airspace and advanced technology spending during 11th-Five Year, further boost the market of CNC machine tools.
- Good Friend will expand the forklift truck business to become its second core business, to capitalized the industry's good prospect.
- Production shifts to new plants to enhance capacity for each product.
- Our preliminary estimates put Good Friend's FY12/07F turnover and net profit at RMB791.4m and RMB81.0m respectively.
- This counter is currently trading at historical P/E of 34.2x and 27.1x FY12/07F P/E based on our preliminary estimate.

CNC machine tools – core business. Based in Hangzhou in PRC, Good Friend is principally engaged in the design and production of computer numerical control (CNC) machine tools, parking garage structures and forklift trucks. CNC machine tools are the major source of revenue for Good Friend. In FY12/06, the company sold 1,151 units, mainly in China, generating RMB467.3m or 76.5% of total sales. Good Friend sold 4,828 units of parking garage structures (RMB85.2m in sales) and 957 units of forklift trucks (RMB58.3m) last year.

Table 1: Sales breakdown

RMBm	2005	%	2006	%
Machine tools	426.4	76.5	467.3	76.5
Parking garage structures	74.4	13.3	85.3	14.0
Forklift trucks	56.8	10.2	58.3	9.5
Total	557.7	100.0	611.0	100.0

Source: Company data

Witnessed strong demand for CNC machine tools in China in these years. CNC machine tools is a mechanical device typically used to fabricate components by selective removal of materials. The introduction of CNC machine radically changed the manufacturing and industrial industry, as improvement in quality and consistency can be achieved with the increased automation and precision of manufacturing process with CNC machining. Thus CNC machine became an essential component of the industrial and manufacturing sectors. Between 2002 and 2005,

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China's sales of machine tools grew at a CAGR of 22.7% and of CNC machine tools at a CAGR of 47.3%.

Leveraging on its parent's advanced technology. Good Friend is the largest foreign-invested producer of CNC machine tools in the PRC. Its parent, Taiwan's Fair Friend Group, has set up alliance with Japanese (EMC and F.F. Japan) and US (S.M.S) partners in producing CNC machine tools. With comfortable supports from the parent, Good Friend is able to develop core products by deploying innovative research methods and advanced technologies, which gives the company a competitive edge against local peers.

Solid demand from car industry. The company's customers are mainly manufacturers from the car, electronics and mould processing industries. Currently, car manufacturers accounted for c.50.0% of Good Friend's sales, up from 21.4% in 2004. China is currently the world's second largest auto market behind the US, with an output of 7.3m units (up 27.3% YoY) and sales of 7.2m units (up 25.1% YoY) in 2006, according to CCID Consulting. According to the China Automobile Industry Association, the country's total car output is expected to reach 8.5m units in 2007, up 16.4% YoY. The growing production and consumption of car in China, fueling the demand for CNC machine tools as CNC machine tools is one of the essential tools in making car. Hence demand for Good Friend's CNC machine tools is likely to maintain solid.

To produce higher-end CNC machine tools. According to the 11th Five-Year Plan, Chinese government intends to increase spending on the military, aerospace and advanced technology. Hence we anticipate that the country's demand for higher-end CNC machine tools will increase significantly during the period. Currently, Good Friend manufactures small to mid-size machine tools. In view of China's increasing demand for higher-end products, the company plans to focus more efforts and resources on R&D to develop higher-end CNC machine tools. In addition, as an attempt to strengthen connection internally and create synergy, we expect its parent to inject its high-end assets like Leadwell and Sanco into Good Friend in the future.

New production arrangement boosts capacity. The company has two production plants, in Xiasha and Xiaoshan. Production of forklift truck has been shifted to Phase I Xiasha plant, which launched operation at the beginning of 2007, from Xiaoshan. Phase II Xiasha, which should be finished in 2H07, will, upon completion, takeover the production of parking garage structures, leaving Xiaoshan to focus on CNC machine tools and Phase I Xiasha on forklift trucks. This new arrangement will enhance the company's manufacturing capacity to 2,400 units of CNC machine tools, 10,000 units of parking garage structures and 5,000 units of forklift trucks by end of 2007.

Table 2: Capacity

(Units)	Current capacity	New capacity
Machine tools	1,800	2,400
Parking garage structures	8,000	10,000
Forklift trucks	2,000	5,000

Source: SBI E2-Capital

Forklift truck to become second core business. With China gradually transforming itself into heavy industrial country, China's forklift truck industry is growing at the rapid pace as forklift trucks can be used in many industries for the purpose of transporting goods. China's forklift truck sector grew at an average of 35.0% between 2000 and 2006 and the rate is expected to remain at 20.0-30.0% going forward. Currently, Good Friend has about 3.5% of the market. This year, the introduction of new models of electronic forklift trucks was well received abroad, resulting in an increase in overseas market share. The capacity of Phase Xiasha production plant, which produces forklift trucks, is expected to increase to 5,000 units in 2007, from 2,000 last year. Good Friend targets to sell 2,000 units of forklift trucks this year and 5,000 units in 2008 and make the division its second core business.

Garage structure business. Good Friend's car parking garage structures have been used in residential buildings, commercial and office building, hotels and shopping malls. Its parking garage structure business will concentrate on Hong Kong and Macau because of their limited land resources and high demand for multi-story parking.

1H FY12/07A result review. Turnover increased 35.2% YoY to RMB366.8m, with 71.4% generated by CNC machine tools (RMB262.0m sales). Net profit increased 163.3% YoY to RMB41.3m. The gross profit margin widened from 22.4% to 26.1%, due to changes in the sales mix (larger share of high-margin products).

Table 3: 1H FY12/07A sales breakdown

RMBm	1H06	1H07	YoY (%)
Machine tools	206.5	262.0	26.9
Parking garage structures	40.4	59.2	46.5
Forklift trucks	24.3	45.7	88.1
Total	271.3	366.8	35.2

Source: Company data

Table 4: Interim results

Six months to Jun	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	EPS (RMB)	DPS (RMB)
1H FY06	271.3	60.7	22.4	16.6	5.3	15.7	0.05	0.04
1H FY07	366.8	95.8	26.1	46.2	10.6	41.3	0.12	0.04
YoY (%)	35.2	57.8		178.3		21.5	140.0	-

Source: SBI E2-Capital

Preliminary estimates and valuation. Based on our preliminary forecasts, CNC machine tools remains as the core revenue contributor for the company, we expect the FY12/07F top line grow 29.5% to RMB791.4m. With the increase focus on CNC machine tools, which offers higher profit margin, our preliminary estimates put Good Friend's bottom line at around RMB81.0m, representing an increase of 52.6%. Currently, Good Friend is trading at the historical P/E of 34.2x and 27.1x FY12/07F P/E based on our estimate.

Corporate governance. Good Friend was listed on the Hong Kong Stock Exchange in early 2006. The company has appointed Deloitte Touche Tohmatsu as its auditor. Its major shareholder, Good Friend (Hong Kong) Corp Ltd, holds a 75.0% stake.

Table 5: Peer comparison

Company name	Ticker	Market Cap (US\$m)	P/E (x)			ROA (%)	ROE (%)
			Historical	Current	1-yr Fwd		
Jiaoda Kunji	300 HK	1,055.2	61.3	33.6	25.4	7.4	14.6
Shenyang Machine Tool	000410 CH	1,720.1	na	50.5	30.3	2.5	12.0
Anhui Heli	600761 CH	1,714.3	na	39.6	28.7	13.0	18.4
Awea Mechantronic	1530 TT	170.9	12.6	9.8	8.1	17.5	35.6
Tong-Tai Machine and Tool	4526 TT	212.5	na	10.5	9.4	15.5	27.4
Kitagawa Iron Works	6317 JP	196.8	19.0	na	na	2.3	5.6
Amada	6113 JP	4,537.5	18.9	17.1	16.2	5.2	6.8
Mori Seiki	6141 JP	2,564.7	18.1	16.4	15.0	9.8	13.1
OKUMA	6103 JP	2,569.3	19.2	17.5	15.7	8.3	16.4
Hardinge	HDNG US	393.2	21.7	16.2	14.0	4.4	9.4
Doosan Infracore Company	042670 KS	8,081.6	50.0	23.6	19.2	na	na
<i>Average</i>			27.6	23.5	18.2		

Source: SBI E2-Capital and Bloomberg

Table 6: P&L

Year end Dec (RMBm)	04A	05A	06A	1H06A	1H07A
Revenue	379.6	557.7	611.0	271.3	366.8
Cost of sales	(279.5)	(438.3)	(457.8)	(201.6)	(271.1)
Gross profit	100.1	119.3	153.2	60.7	95.8
Other income	4.8	6.8	8.9	3.8	3.4
Distribution costs	(44.4)	(54.5)	(69.0)	(31.5)	(33.7)
Administrative expenses	(14.2)	(18.0)	(29.7)	(11.5)	(17.5)
Other operating expenses	(3.1)	(1.2)	(3.7)	(3.3)	(0.5)
Finance costs	(3.6)	(5.2)	(2.5)	(1.7)	(1.2)
Before tax profit	39.6	47.1	57.4	16.6	46.2
Taxation	(3.3)	(4.8)	(4.3)	(0.9)	(4.9)
Profit attributable to equity holders	36.3	42.4	53.1	15.7	41.3
Dividend	-	-	14.0	14.0	14.0
EPS - basic (RMB)	0.17	0.20	0.19	0.05	0.12

Source: SBI E2-Capital