Company report

Industrials
Electrical Equipment
Equity – China

HSBC Global Research

Zhuzhou CSR Times (3898 HK)

Buy: New business set to drive future growth

- **Company management is upbeat on the company outlook at post result briefing.**
- **Good cash earnings from rail related business with multiple upsides from non-rail and overseas business expansion.**
- **Establish a Buy rating with a fair value target price of HKD63 based on DCF. FY15 and FY16 EPS +15% and +9% respectively.**

Upbeat post result briefing – We participated in the post result analyst briefing which well attended by investor and sell-side analysts after market close today. The overall tone is quite positive from the management on the outlook. Chinese domestic rail equipment related orders for electrical component would remain solid in 2015 with MU (multiple unit or high speed passenger train) likely to see growth at 20% YoY which is higher than we anticipated. Zhuzhou has started co-operating with CNR Corp (6199 HK, HKD10.82, Overweight (V)) on electrical component products and could start seeing orders from 2016. The company used to rely on CSR Corp (1766 HK, HKD9.96, Overweight) on overseas related orders, but the management expects it could start seeing direct export of electrical component for rail equipment in the near future especially in the UK market. The management expects overseas revenue could increase from the current 9% to 20% over the next 3 to 5 years.

Multiple opportunities from non-railway businesses – One of the company's major long-term upside drivers is its ability to apply its power conversion technology in the broader industrial manufacturing in China. We think the company is getting close to harvest its effort over recent years on the non-railway businesses. Its IGBT (insulated gate bipolar transistor) production facility is likely to breakeven in 2016 which is in line with our expectation but likely to be ahead of consensus. It is also looking to get involved in electric vehicle components with CSR Corp. There is potential for additional subway signalling system order in 2015. The recent acquisition of deep sea robotics business in UK also could offer long term potential in offshore marine engineering products.

Beneficiary from Chinese rail industry consolidation and beyond – Zhuzhou remains our preferred Chinese infrastructure stock trading at 15.4x FY15e PER with 16% FY15 EPS growth. Its railway business market share in China has the potential to double post the merger of CSR Corp and CNR Corp. Its faster-than-expected IGBT business progress and other non-rail business could also present further earnings upside.

Index^	HSCEI
Index level	12,156
RIC	3898.HK
Bloomberg	3898 HK

Source: HSBC

Enterprise value (CNYm)	33948
Free float (%)	42
Market cap (USDm)	6,854
Market cap (HKDm)	53,190

Source: HSBC

Buy

Target price	(HKD)	63.00
Share price	(HKD)	45.25
Upside/Downside (%)		39.2

Dec	2014a	2015e	2016e
HSBC EPS	2.04	2.35	2.42
HSBC PE	17.8	15.4	15.0

Performance	1M	3M	12M
Absolute (%)	7.1	35.7	79.6
Relative^ (%)	6.3	31.1	39.3

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Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (CNYm)				
Revenue	12,676	15,335	16,168	15,335
EBITDA	2,847	3,379	3,580	3,725
Depreciation & amortisation	-187	-248	-316	-344
Operating profit/EBIT	2,660	3,131	3,264	3,381
Net interest	43	30	31	32
PBT	2,755	3,213	3,341	3,459
Taxation	-363	-450	-501	-519
Net profit	2,395	2,766	2,844	2,944
Cash flow summary (CNYm)				
Cash flow from operations	1,966	1,930	2,698	2,787
Capex	-319	-351	-582	-640
Cash flow from investment	-2,178	2,654	-582	-640
Dividends	-470	-553	-569	-589
Change in net debt	481	-5,764	-2,395	806
Balance sheet summary (CNYm)				
Intangible fixed assets	282	251	229	168
Tangible fixed assets	2,240	3,331	3,611	3,957
Current assets	14,166	17,948	20,741	20,422
Cash & others	2,680	8,377	10,773	9,969
Total assets	16,925	21,766	24,818	24,784
Operating liabilities	5,631	5,298	5,643	5,984
Gross debt	108	42	43	45
Net debt	-2,572	-8,335	-10,730	-9,924
Shareholders funds	10,991	16,278	18,998	18,608
Invested capital	8,377	7,854	8,165	8,595

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	43.1	21.0	5.4	-5.2
EBITDA	55.2	18.7	5.9	4.0
Operating profit	59.9	17.7	4.2	3.6
PBT	61.7	16.6	4.0	3.5
HSBC EPS	63.2	15.5	2.8	3.5
Ratios (%)				
Revenue/IC (x)	1.8	1.9	2.0	1.8
ROIC	32.4	33.2	34.6	34.3
ROE	21.8	17.0	16.1	15.7
ROA	13.9	12.6	12.1	11.7
EBITDA margin	22.5	22.0	22.1	24.3
Operating profit margin	21.0	20.4	20.2	22.0
EBITDA/net interest (x)				
Net debt/equity	-23.0	-50.8	-56.1	-53.0
Net debt/EBITDA (x)	-0.9	-2.5	-3.0	-2.7
CF from operations/net debt				
Per share data (CNY)				
EPS reported (fully diluted)	2.04	2.35	2.42	2.50
DPS	0.40	0.47	0.48	0.50
Book value	9.35	13.85	16.16	15.83

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	3.1	2.2	2.0	2.1
EV/EBITDA	13.9	10.0	8.8	8.7
EV/IC	4.7	4.3	3.9	3.8
PE*	17.8	15.4	15.0	14.4
P/Book value	3.9	2.6	2.2	2.3
Dividend yield (%)	1.1	1.3	1.3	1.4

Note: * = Based on HSBC EPS (fully diluted)

Price relative

Source: HSBC

Note: price at close of 20 Mar 2015

Multiple reasons to own the stock

- We think Zhuzhou has a better growth outlook in rail equipment related orders than CSR Corp due to the merger.
- Non railway business progress is faster than expected which could drive medium term earnings upside.
- Establish Buy rating, with a fair value target price of HKD63. FY15 and FY16 EPS +15% and +9%.

Key takeaway from analyst briefing

Railway equipment business growth outpace train maker

- Zhuzhou management expects its train borne electrical component for MU product to see +20% YoY growth in 2015 which should be above market expectation. Components for locomotive would be flat in 2015 as strong overseas delivery (such as in South Africa) would offset a soft domestic demand. Subway components would remain strong and we forecast +30% YoY growth.
- The company noted that the electrical component for MU product is almost 90% for new units. Not only the MU new unit demand would be solid in 2015, they think the upcoming major maintenance in the coming two years for MU could also see potential incremental demand for replacement component.
- It has developed a new model for train safety equipment which generated Rmb575m in 2014 or 4.5% of total revenue. According to the management, the new model could attract twice the average selling price as the older model. It is currently being tested at two railway bureaus and should start to see sales during 2015. We conservatively assume the train safety equipment sales will increase by 30% YoY to Rmb747m in 2015 with upside risk.
- Profitability for rail related products is expected to be steady at between 35-40%.
- It is interesting that the management is starting to say more about the potential benefit from CSR Corp and CNR Corp merger. Zhuzhou has started to work closely with various CNR Corp subsidiaries and could see sales to CNR Corp in 2016. We believe Zhuzhou is the biggest beneficiary of the CSR Corp and CNR Corp merger and its domestic addressable market share would eventually double over time. However, we have yet to incorporate the upside from CNR Corp demand due to the timing of the merger completion, the co-operation process and the potential

acquisition of equivalent component business from CNR Corp. As the clarity of order timing from CNR Corp improves, we think Zhuzhou's share price may continue to be re-rated.

Non-railway business may lead the future growth

- Following on from the business update conference call in February 2015, the management indicated that the IGBT production facility in China is progressing well with an estimated revenue of Rmb800m to Rmb1bn likely in 2015. This is higher than our expectation and likely the market expectation. Furthermore, the management indicated the more optimistic view on the break-even point for the facility could be in 2016 which should also be better than market expectation. After we revise up our revenue forecast for IGBT in 2015 to Rmb803m, we expect the IGBT business to generate a loss of Rmb108m versus Rmb123m of loss previously.
- The IGBT products have been installed on most of Zhuzhou's railway equipment with a small portion for the China State Grid.
- Subway signalling product is yet to make a further breakthrough in terms of new order but the management is hopeful in 2015 for additional orders.

Potential risks could be acquisitions

- The company' recent acquisition of SMD Ltd which focuses on deep sea robotics for GBP108m was not well received by investors. However we note the acquisition would contribute in a mild positive way to Zhuzhou's bottom line rather than a subtraction.
- The key concern at the briefing is the company may look to acquire other marine engineering businesses from CSR Corp to create more synergy. While the timing is not certain, we think a potential acquisition in additional marine engineering product may come under the scrutiny of shareholders.

Earnings change summary – FY15 and FY16 EPS

- We incorporate the revenue from SMD Ltd which would be fully consolidated from April 2015 and expects to generate Rmb800m of revenue. We also changed the revenue forecast for each train borne component products based on management expectation. Total revenue for 2015 is revised up by 23.4% and 19.7% in 2016.
- Profitability assumption is reduced to reflect the SMD contribution which generates circa 20% GP margin which is lower than the company average GP margin. The increased revenue contribution from IGBT business which assumes to generate 25% GP margin in 2015 and 30% in 2016 also subtract from the overall profitability level.
- We revise up FY15 and FY16 EPS by +15% and +9% respectively. Our FY15 EPS of Rmb2.35 is about 15% above consensus and FY16 EPS of Rmb2.42 is about 2% above consensus according to Thomson Reuters.

Zhuzhou CSR – earnings change table

RMB m	2015 new	2015 old	YoY%	2016 new	2016 old	YoY%
Locomotive	3,704	3,197	15.9%	3,890	3,357	15.9%
EMU	5,711	4,775	19.6%	5,140	4,297	19.6%
Metropolitan rail system	1,570	1,491	5.3%	1,884	1,789	5.3%
Train power converters and control systems	10,985	9,463	16.1%	10,913	9,443	15.6%
Train operation safety equipment	747	685	9.0%	896	822	9.0%
Railway maintenance vehicle related products	1,149	1,103	4.1%	1,149	1,103	4.1%
Power semiconductor devices	803	649	23.6%	1,558	1,558	0.0%
Others	852	530	60.6%	852	583	46.0%
SMD (deep sea robotics)	800	0	na	800	0	na
Revenue	**15,335**	**12,430**	**23.4%**	**16,168**	**13,510**	**19.7%**
Cost of sales	-10,093	-7,756	30.1%	-10,631	-8,462	25.6%
Gross profit	**5,242**	**4,675**	**12.1%**	**5,537**	**5,048**	**9.7%**
GP margin	*34.2%*	*37.6%*		*34.2%*	*37.4%*	
Other revenue and gains	452	108	320.0%	405	91	346.9%
Selling and distribution costs	-901	-684	31.8%	-922	-716	28.8%
Administrative expenses	-1,541	-1,367	12.7%	-1,629	-1,432	13.8%
Business tax	-121	-124	-2.9%	-127	-135	-5.8%
Profit/(loss) from operations [EBIT]	**3,131**	**2,607**	**20.1%**	**3,264**	**2,856**	**14.3%**
EBIT margin	20.4%	21.0%		20.2%	21.1%	
Finance costs	30	73	-58.7%	31	74	-58.1%
Share of profit of an associate/jointly controlled entity	52	140	-63.1%	46	126	-63.1%
Profit before tax	**3,213**	**2,820**	**13.9%**	**3,341**	**3,056**	**9.3%**
Income tax expenses	-450	-423	6.3%	-501	-458	9.3%
Net profit after tax	2,763	2,397	15.3%	2,840	2,597	9.3%
Net profit margin	***18.0%***	***19.3%***		***16.5%***	***19.2%***	
Attributable to:						
Equity holder of the Company	2,766	2,398	15.3%	2,844	2,599	9.4%
Minority interests	-3	-1		-3	-1	

Source: HSBC estimate

Valuation and risks

Zhuzhou CSR Times Electric (3898 HK, Buy, target price HKD63)

We value Zhuzhou using a DCF approach based on a WACC of 8.1% (previously 8.5%). Our key assumptions, which are all unchanged, include: risk-free rate of 3.5% (unchanged); equity risk premium of 5.5% (vs 6.5% previously); terminal growth rate of 3.5% (unchanged); and long-term target debt/(debt + equity) of 20% (previously 30% and we lowered it to be in line with management's formal target on financial leverage) and an equity beta of 1 (unchanged).

Our DCF-based fair value target price is HKD63 (from a 12-month forward target price of HKD53.20), which implies a FY15e PE of 21.4x. We establish a Buy rating.

Key downside risks: the production yield of the new IGBT plant is insufficient; potential overseas acquisitions and expansion and potential business risks related to deep sea robotics business.

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

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For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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As of 23 March 2015, the distribution of all ratings published is as follows:

Buy	41%	(30% of these provided with Investment Banking Services)
Hold	39%	(28% of these provided with Investment Banking Services)
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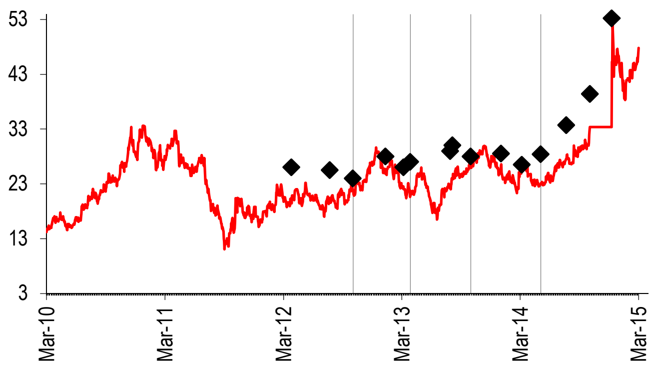
For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

Share price and rating changes for long-term investment opportunities

Zhuzhou CSR Times (3898.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight (V)	Neutral (V)	23 October 2012
Neutral (V)	Overweight (V)	17 April 2013
Overweight (V)	Neutral (V)	21 October 2013
Neutral (V)	Overweight (V)	25 May 2014
Target Price	**Value**	**Date**
Price 1	26.00	16 April 2012
Price 2	25.50	13 August 2012
Price 3	24.00	23 October 2012
Price 4	28.00	31 January 2013
Price 5	26.00	28 March 2013
Price 6	27.00	17 April 2013
Price 7	29.00	19 August 2013
Price 8	30.00	26 August 2013
Price 9	28.00	21 October 2013
Price 10	28.50	23 January 2014
Price 11	26.50	28 March 2014
Price 12	28.40	25 May 2014
Price 13	33.70	12 August 2014
Price 14	39.40	24 October 2014
Price 15	53.20	30 December 2014

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ZHUZHOU CSR TIMES	3898.HK	47.80	23-Mar-2015	4, 11

Source: HSBC

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