



HONG KONG

The BMW N20 engine made by Xincheng



1148 HK **Outperform**
Price (at 07:59, 17 Mar 2015 GMT) **HK\$2.80**

Valuation	HK\$	4.50
- PER		
12-month target	HK\$	4.50
Upside/Downside	%	+60.7
12-month TSR	%	+60.7
Volatility Index		High
GICS sector		Automobiles & Components
Market cap	HK\$m	3,605
Market cap	US\$m	464
Free float	%	32
30-day avg turnover	US\$m	0.4
Number shares on issue	m	1,287

Investment fundamentals

Year end 31 Dec	2013A	2014E	2015E	2016E
Revenue	m 2,586.2	2,752.7	3,649.0	4,043.9
EBIT	m 334.7	385.7	629.7	752.5
EBIT growth	% -8.1	15.2	63.3	19.5
Reported profit	m 270.7	288.1	461.6	554.0
EPS rep	Rmb 0.22	0.22	0.36	0.43
EPS rep growth	% -28.0	0.7	60.2	20.0
PER rep	x 10.2	10.1	6.3	5.2
ROA	% 8.9	7.9	10.5	10.7
ROE	% 15.5	12.4	17.1	17.4
EV/EBITDA	x 5.7	4.9	3.0	2.5
Net debt/equity	% -46.5	-16.4	-5.0	-10.4
P/BV	x 1.3	1.2	1.0	0.8

Source: FactSet, Macquarie Research, March 2015
 (all figures in Rmb unless noted, TP in HKD)

Path to 100% Upside

We view Xincheng Power as an Emerging Leader that can potentially generate a 100% return over 3 years.

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 Macquarie Capital Securities Limited

Xincheng Power

Part of BMW engine supply chain

Initiate coverage with an Outperform rating and TP HK\$4.50

We initiate coverage of Xincheng China Power with an Outperform rating and a target price of HK\$4.50, based on 10x FY15E PER. We expect Xincheng to deliver an EPS CAGR of 39% pa over FY14-16E, driven by strong growth in its engine and parts business supplying BMW Brilliance (BBA). We expect BMW-related revenue to jump more than three-fold over the next three years – from ~Rmb500m in 2014E to ~Rmb1,700m in 2016E.

Leveraging relationship with BMW Brilliance

Xincheng is an associate of Brilliance China Automotive (1114 HK, HK\$13.80, Outperform, TP: HK\$18.30). In 2014 it started to supply BBA with the BMW N20 engine as well as parts. In the longer term, we believe Xincheng will continue to leverage the close relationship between its controlling shareholder Brilliance and BMW AG to obtain more BMW-related business. In addition, tapping into the BMW engine supply chain will help improve Xincheng's R&D capabilities for its own brand engines and potentially bring more business opportunities with other OEMs.

BMW engines are the growth driver

Xincheng was authorized by BMW AG in December 2012 to manufacture the N20 engine, and production started in 2014. The company subsequently became a connection rod supplier in November 2013 and in January 2015 it was awarded a contract for crankshafts. We expect BMW-related revenue to contribute 18% and 38% to Xincheng's overall revenue in 2014E and 2015E, respectively. As the BMW business is more lucrative than Xincheng's own business, we also expect the overall GP margin to expand from below 20% in 2013 to over 25% in 2016E.

We believe Xincheng will be a major beneficiary of the success of BMW, particularly BMW Brilliance's high growth in China. The close strategic relationship between BMW and Brilliance is resulting in more BMW models being locally produced in China ([Brilliance - Maximising potential of line-up](#), February 2015), and therefore creates more opportunities for Xincheng's BMW engine and parts business.

Valuation and risks

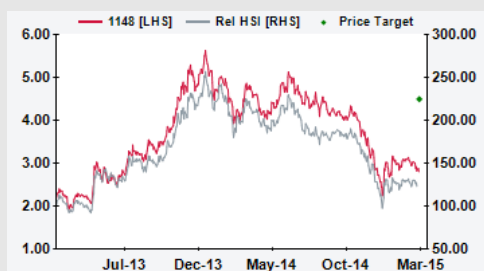
Our target price of HK\$4.50 is based on 10x 2015E PER, in line with the multiple we give for Brilliance. We believe Xincheng will grow faster than Brilliance in the next few years benefiting from the new BMW business and improving engine brand image supported by advanced BMW technology. We believe the high growth potential from the BMW business is still under-appreciated by the market. We are adding the stock to our Emerging Leaders Conviction List, and believe the share price can double in 3 years time. The stock is currently trading on only 6.3x 2015E PER.

Major risks include a significant slowdown in China's auto market, lower-than-expected BMW-related revenue and a decline in Xincheng's own brand engine business.

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1148 HK rel HSI performance, & rec history

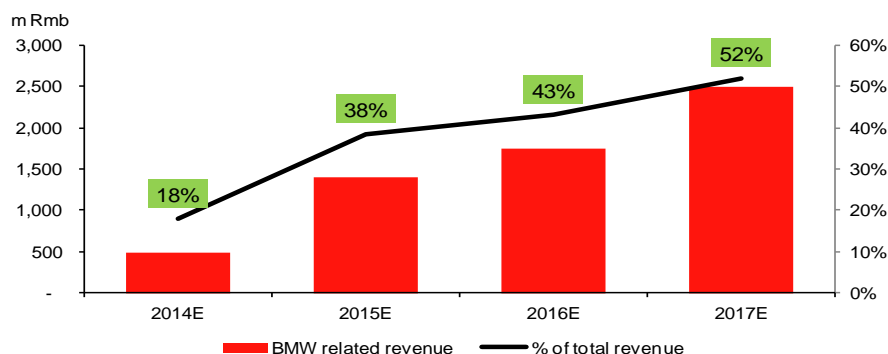


Source: FactSet, Macquarie Research, March 2015

Company profile

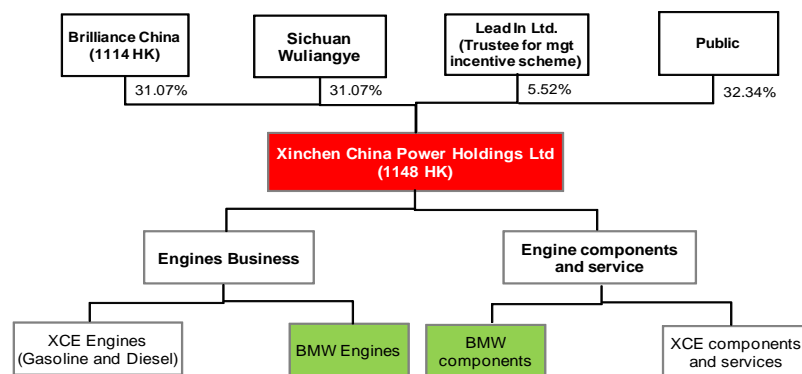
- Xinchen China Power Holdings Limited (1148 HK) is a leading automotive engine manufacturer in China. Xinchen develops, manufactures and sells engines for passenger and light duty commercial vehicles. The company sells its products under the brand name of XCE 新晨动力.
- Xinchen was listed on the main board of the Hong Kong Stock Exchange in March 2013. Xinchen is the engines entity under Huachen Group, which owns 42.48% of Brilliance China (BCA, 1114 HK). As at 30 June 2014, Brilliance owned 31.07% of Xinchen’s outstanding shares while Sichuan Wuliangye is the other major shareholder, also with a 31.07% interest in Xinchen.
- Xinchen was authorized by BMW AG of Germany in December 2012 to manufacture the N20 engine, and production started in 2014. The company has been seeking a more extensive and comprehensive strategic cooperation with BMW AG and BMW Brilliance (BBA, the joint venture between BCA and BMW AG) by initiating the N20 engine project, with an aim to eventually become a stable engine and parts supplier to BBA and BMW AG.
- Xinchen subsequently acquired the connection rod and crankshaft production lines from Huachen group in November 2013 and January 2015, respectively. The connection rod and crankshaft are two of the five key engines parts, and these transactions will further strengthen Xinchen’s relationship and open more business opportunities with BMW and BBA.

Fig 1 Rising revenue contribution from BMW business



Source: Company data, Macquarie Research, March 2015

Fig 2 Xinchen structure and business segments



Note: The shareholding structure is as at 30 June 2014
Source: Company data, Macquarie Research, March 2015

Part of BMW engine supply chain

Initiating coverage with an Outperform rating and TP of HK\$4.50

We initiate coverage on Xinchen Power with an Outperform rating and target price of HK\$4.50, which is based on 10x FY15E PER.

**BMW business
boosts revenue by
22% pa in 2015-
2016E**

BMW business boosts revenue and profitability in 2015-2016E

Xinchen started to manufacture and sell the BMW N20 engine and parts in 2014. We expect BMW-related revenue to jump more than three-fold over the next three years – from ~Rmb500m in 2014E to ~Rmb1,700m in 2016E, boosting overall revenue by 22% pa in 2015-2016E. The BMW-related revenue is estimated based on the contracted transaction limitations agreed between BMW Brilliance and Xinchen; thus there is limited downside risk. Moreover, since the BMW business has a much higher GP margin than Xinchen's own business, we expect the overall GP margin will expand from 19.7% in 2013 to 26% in 2016E.

Fig 3 Xinchen financial highlights

(m Rmb, except for EPS)	2012	2013	2014E	2015E	2016E
Total sales revenue	2,573	2,586	2,753	3,649	4,044
YoY	11%	1%	6%	33%	11%
BMW-related revenue	-	-	492	1,400	1,743
YoY	-	-	-	185%	25%
GP margin	20.1%	19.7%	21.7%	24.9%	26.1%
NPAT	290	271	288	462	554
YoY	11%	-7%	6%	60%	20%
EPS (Rmb)	0.31	0.22	0.22	0.36	0.43
EPS (HKD)	0.38	0.28	0.28	0.45	0.54
PER (x)			10.0	6.3	5.2

Note: PER is based on HK\$2.80 as of 17 March 2015 market close

Source: Company data, Macquarie Research, March 2015

**BMW business
opens the door to
long-term growth**

Tapping into the BMW engine supply chain opens the door to growth

In the longer term, we believe Xinchen will continue to leverage the close relationship between its controlling shareholder Brilliance and BMW AG to obtain more BMW-related business. As BMW has committed to three more models to be locally produced in China, Xinchen is likely to become the long-term beneficiary of BMW's success in China – assuming it can prove itself by manufacturing the N20 engines and parts. Xinchen has been in negotiations with BBA for the transfer of the improved crankshaft production line for the new generation Bx8 engines, which will be deployed with the new BMW front-wheel-drive platform. This opens room for continued high growth beyond 2016.

**Attractive valuation
with 60% EPS
growth in 2015E**

Attractive valuation with good 12-month visibility

We expect Xinchen to report strong EPS growth of 60% in 2015E and further growth of 20% in 2016E. The share price corrected from HK\$4.40 since last November (vs HSI +4.1%) due to concerns over the sluggish performance of its own brand engines and Brilliance's slower growth in 2015, but it bottomed out at HK\$2.21 in January and has rallied over 30% since the announcement of a new contract from BBA. The current share price implies only 6.3x/5.2x 2015/16E PER, which is very attractive among the global auto parts names. Our target price of HK\$4.50 is based on 10x 2015E PER. We believe 2015 will be a strong year for Xinchen.

BMW business – the growth driver

Ramping BMW engine business drives growth

The BMW N20 engine – ramping production, boosting revenue

The BMW N20 engine is a turbocharged straight-4-cylinder gasoline engine that has been in production since 2011.

While the N20 engine is a straight-4-cylinder, it is considered a replacement for its straight-6 cylinder predecessors, the N52 and N53, because it produces similar horsepower with greater lower-end torque and better efficiency. The N20 was placed in [Wards Top 10 Engines in 2012](#) for its innovative 4-cylinder design for smaller engines as emission standards are becoming more stringent worldwide.

Fig 4 The award winning high efficiency 4-cylinder N20 engine



Source: Company data, February 2015

Fig 5 N20 offers high horsepower and better efficiency with a turbo charger



Source: Company data, February 2015

Highly efficient N20 engines are widely used on BMW models

As shown in Fig 6, the N20 engine is currently deployed on all three BMW models locally produced by BBA and is the most widely used engine among various BMW engines. Xinchen received authorisation from BMW in December 2012 to manufacture the N20 engine and entered into a further agreement with BBA in May 2014 to supply the N20 engine as well as the connection rod, a key part of the engine that can also be used on other BMW engines.

Fig 6 N20 engine is widely used on all locally produced BMW models

Engine models		3 Series sedan				5 Series sedan				X1 SUV		
		316i	320Li	328Li	335Li	520Li	525Li	530Li	535Li	Drive18i	Drive20i	Drive28i
4-cylinder gasoline	N13	✓										
	N20		✓	✓		✓	✓			✓	✓	
	N46									✓		
6-cylinder gasoline	N52								✓			
	N55				✓						✓	

Source: Company data, Macquarie Research, February 2015

The production line for the BMW N20 engine was ready in June 2014, with a designed capacity of 50,000 units. Deliveries commenced in September 2014. The engines are sold to BBA and currently only deployed on the BMW 5 Series 520Li. The engines will also be supplied to the new premium Jinbei MPV, *Huasong 7*, which was officially launched in November 2014 and should start shipments in 1Q 2015.

Volume assumptions – rising volume and capacity

N20 unit sales in September 2014 were 1,000 units, and we believe production gradually ramped to 3,000 units per month by December 2014.

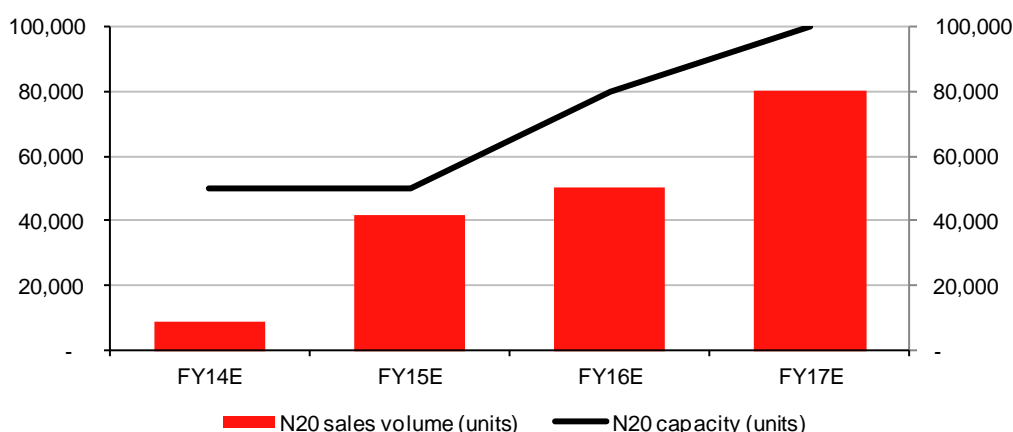
- We have therefore estimated sales volume for 2014 to be 9,000 units. (1,000 units in September, 2,500 units each in October and November, 3,000 units in December).
- For 2015, we assume Xinchen can sell 3,000 units per month in the 1H and 4,000 units in the 2H, totalling 42,000 units for the full year; this would represent an 84% utilisation rate of the current 50,000 unit capacity.

We expect capacity expansion by 2016, but it may come earlier

The current capacity of 50,000 units can be expanded to 100,000 units with the Phase II factory. The exact schedule of the Phase II factory has not been announced yet, so we assume the capacity will only be expanded to 100,000 units by the end of 2016, providing effective capacity for 2016 of 80,000 units. On this assumption, 2017 annual capacity will be 100,000 units.

- For 2016, we expect Xinchen can reach current full capacity of 50,000 units. There is upside to this assumption should new capacity come on stream earlier than expected.
- For 2017, we assume sales volume of the N20 engine can reach 80,000 units.

Fig 7 Estimated N20 sales volume and capacity



Source: Company data, Macquarie Research, February 2015

ASP assumptions – based on MRSP of BMW 520Li

The other major assumption we have to make is the ASP of N20 engines.

- As shown in Fig 8, we start from the BMW 520Li MRSP of Rmb429,000 and assumed a GP margin of 23%, and this will result in a direct cost (COGS, VAT included) of Rmb330,000.
- The engine price is usually 10%-15% of the cost of a whole vehicle, and we take the mid-point 12% due to a lack of track record on pricing. After deduction of 17% VAT, the estimated ASP of the N20 engine is Rmb33,000/unit.
- In addition, we assume that the ASP will come down 5% per year in 2015 and 2016 as Xinchen gradually achieves production scale, as OEMs normally would require price cuts on parts each year.
- We believe the ASP of this engine will be significantly lowered to Rmb25,000 in 2017 as it approaches the end of its life cycle, and replacements should be launched by then.

Est. ASP of Rmb33k is based on 12% of 520Li COGS

Fig 8 Estimated ASP of Xinchen manufactured BMW N20 engines

	2014E	2015E	2016E	2017E
MRSP of BMW 520Li (k Rmb)	429			
COGS (Assume GPM 23%)	330			
est. ASP (12% of COS, ex-VAT 17%)	33	31	30	25

Source: Company data, Macquarie Research, February 2015

The engine 5 Cs – now authorised to produce 2 Cs for BMW

An engine, which converts energy into useful mechanical motion, is the most crucial part of an automobile. There are five key components of an engine, namely, connection rod, crankshaft, cylinder block, camshaft and cylinder head, and they are often referred to the engine 5 Cs. Fig 9 shows their key functions.

Fig 9 Key functions of the 5 Cs

01	Connection rod	A connection rod is the most essential engine part, placed between piston and crankshaft. It converts the linear reciprocating motion of piston to rotational motion for engine power transmission. It is subject to extremely high mechanical impacts, rotational moments and high temperatures.
02	Crankshaft	A crankshaft is a mechanical part that converts between reciprocating motion and rotational motion. It is subject to high-speed rotation and a high-impact environment.
03	Cylinder block	A cylinder block is an integrated structure comprising the cylinder(s) of an engine and often some or all of their associated surrounding structures. It is the place where energy created from ignition and combustion is transmitted to pistons and crankshafts.
04	Camshaft	A camshaft is a shaft to which a cam is fastened or of which a cam forms an integral part.
05	Cylinder head	A cylinder head is on top of the cylinder block. It closes in the top of the cylinder, forming the combustion chamber.

Note: Based on information from a variety of engine web-sites

Source: Macquarie Research, February 2015

Fig 10 5 Cs are key for engines



Source: ChinaAutoWeb, February 2015

Xinchen is now authorised to produce 2 of 5 key BMW engine Cs

Apart from manufacturing the BMW N20 engines, Xinchen subsequently acquired the [connection rod](#) and [crankshaft](#) production lines from Huachen group in November 2013 and January 2015, respectively. Xinchen manufactures these two key engine components, and BBA is the exclusive buyer of these products. Xinchen highly values the strategic relationship with BMW and is making steady progress on securing more business opportunities with BMW and BBA.

Xinchen started manufacturing and selling connection rods in early 2014 and guided 2014 full year deliveries to be around 1m units and 1.6m units for 2015. This new parts business significantly boosted Xinchen’s engines components and service revenue to Rmb137m in 1H2014, up from Rmb19m in 1H2013.

Going forward, we expect the contribution to Xinchen’s overall revenue will remain below 10%, but being a BMW core engine component supplier should help improve the quality and brand image of Xinchen’s own engine business

In addition, the GP margin on engine parts is much higher than engines. We expect the GP margin for the engine components and service business will stay above 40% in 2015-17E, as compared with below 20% GP margins on Xinchen’s own brand engine business. Thus, the GP contribution level from connection rods, crankshafts and any other potential parts should be higher than their revenue contribution.

BMW transaction caps support growth visibility

BMW transaction limitations underpin volume

Currently, all BMW N20 engines and engine parts manufactured by Xinchen are to be sold to BBA and Brilliance for the Huasong MPV, and Xinchen cannot sell them elsewhere based on agreements with BMW. In the latest HKEx [announcement](#) (January 2015, page 24), Xinchen disclosed the annual transaction caps of BMW related business for 2014 to 2016 as shown in Fig 11.

We estimate that the utilisation rate of the annual cap would be 95%, 85% and 100% in 2014-16. We assume a utilisation rate of just 85% for 2015 since Xinchen’s new crankshaft business was only recently secured in late January, and it would normally experience a few months’ ramp-up. We note, however, that Xinchen has proved to be on schedule for launching new BMW related businesses, and there is a chance the utilisation rate could be higher than 85%; this would provide upside to our 2015E earnings.

Fig 11 Annual caps on sales revenue by Xinchen to BBA

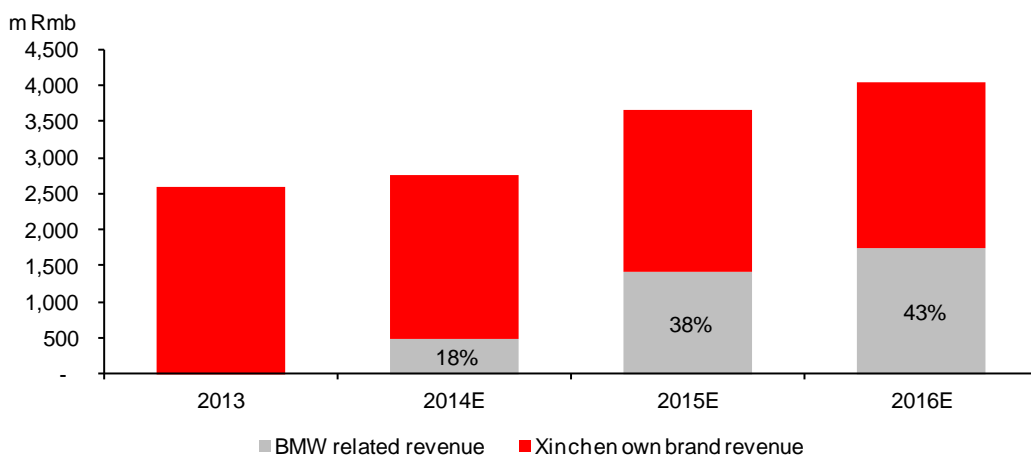
(m Rmb)	2014	2015	2016
Annual caps for BBA transactions	518	1,647	1,743
est. utilisation rate of cap	95%	85%	100%
est. annual transactions with BBA	492	1,400	1,743

Source: Company data, Macquarie Research, February 2015

Big jump in BMW revenue in 2014-16E

The revenue contribution from BMW businesses only started from 2014, and on our estimates, the revenue contribution should accelerate over the next three years and reach 43% of Xinchen’s overall revenue in 2016.

Fig 12 Big jumps in revenue contribution from BMW business



Source: Company data, Macquarie Research, February 2015

Beyond 2016... limited visibility but hopeful of increased BMW business

Xinchen has only disclosed the BMW transaction limitations until 2016; we believe BMW and BBA are still evaluating Xinchen's capabilities to become a long-term core parts supplier. Therefore, we have limited visibility for growth beyond 2016 at the current stage.

In addition, the new generation of BMW *5 Series* will come to the market in 2017. This would imply the gradual retirement of the current BMW N20 engines. It thus is crucial for Xinchen to secure either the next generation of BMW engines or other parts business.

Future growth rests on next generation BMW engines

Based on the latest HKEx [announcement](#) in January, we learned that BBA has been in the process of upgrading the crankshaft production line to enable it to produce crankshafts for the newer BMW Bx8 engines and expanding the production capacity of the production line as well. BBA and Xinchen are in negotiation for the transfer of Bx8 engines related improvements and the potential supply of the Bx8 finished crankshaft. This highlights the potential for Xinchen's further growth beyond 2016. We believe more colour will be available to the market after BBA announces a more concrete launch time line for its new models, likely in August 2015 during half year results meeting.

Xinchen engines – stable is best

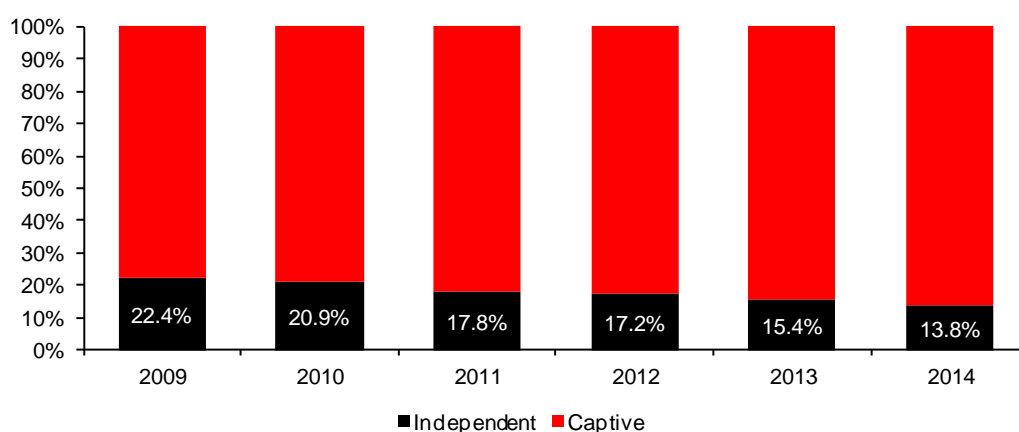
A leading independent branded engine supplier to various OEMs

Xinchen is a leading auto engine manufacturer in the independent branded engine market in China. These engines are branded “XCE 新晨动力” and are mainly supplied to the passenger vehicle (PV) and light commercial vehicle (LCV) markets in China. Major customers include Huachen Group (Zhonghua Brand), Brilliance China (Jinbei Brand), Zhengzhou Nissan, etc. Major customers account for over 70% of overall sales revenue for Xinchen’s own engines.

Engine suppliers can be classified as independent or captive engine manufacturers. Independent branded engines are supplied to various auto OEMs and retain their own brand independent from the brand of the OEMs. In contrast, captive engine manufacturers generally provide their engines exclusively to affiliated auto OEMs and engines adopt the same brands as the OEMs.

It is a tendency that OEMs would prefer to make engines in-house as they can simultaneously design the engines from the initial R&D stage of a new car model. Total sales volume of all independent branded engines actually declined slightly from 2.93m units in 2009 to 2.91m units in 2014, despite the 11.5% CAGR of the China auto market over the same period. As shown in Fig 13, the market share of independent branded engines also came down gradually from 22.4% in 2009 to only 13.8% in 2014. We are cautious on the outlook for the independent engine sector overall.

Fig 13 Declining market share of independent branded engines in China



Source: CAAM, Macquarie Research, February 2015

Competitive edge of Xinchen’s own brand engines

We believe Xinchen has a number of competitive edges that can help it maintain a relatively stable sales volume of its own brand engines including:

- **Close ties with Huachen Group:** Although Xinchen’s engines are independently branded, Xinchen is an integral part of the Huachen Group and is the sole engine entity under this Group. Therefore, Xinchen faces little risk of losing its largest customer or being replaced by other engine manufacturers. The performance of Xinchen engines is closely tied to Huachen Group’s car sales, specifically Zhonghua brand PVs (Fig 15).
- **Product mix:** Xinchen is primarily focused on light-duty engines, and over half of its models have a displacement at or under 1.6L. This is a healthy product mix as most car makers are adopting smaller engines in order to meet the ever-more stringent emission standards in China.
- **Cooperation agreement with FAW Jilin:** Xinchen entered into a cooperation agreement with FAW Jilin and became a supplier in 2011. Based on the agreement, Xinchen will manufacture its own brand engines on FAW Jilin’s engine production line exclusively and then sell to FAW Jilin at a discounted price. Xinchen engines are now deployed on FAW Jilin Senya MPVs (Fig 16). No extra expense or capex has been incurred. The annual capacity of this production line is 40,000 units. The contribution from this cooperation should be fairly stable.

**We cautiously
forecast flat to slow
growth**

- **Enhanced R&D capabilities from BMW relationship:** As Xinchen is producing BMW N20 engines and getting regular support from BMW technicians, we believe Xinchen's own R&D capabilities are being positively influenced and improved. In the long term, after the BMW N20 retires, Xinchen is likely to get the full technology and sell the engine under its own brand. This should also help with Xinchen's own brand performance.

Based on the above reasons, we believe the best case for the Xinchen brand engine business would be to remain stable over the next two years. As shown in Fig 14, we expect gasoline engine sales volume to remain flat YoY in 2015E-2016E as most of Zhonghua's models are sedans, and domestic brand sedan performance continues to be under pressure as SUVs gain share. We are more optimistic on the outlook for diesel engine performance than that for gasoline engines because Xinchen's light-duty engines are attractive to many CV OEMs. Therefore, we estimate diesel engine unit sales can grow 5% pa in 2015E-2016E. Overall, we expect Xinchen brand engines to remain flat or slightly increase over the next two years before we see any concrete improvement in its products or new relationships with other OEMs.

Fig 14 Xinchen brand engines sales volume

Volume (units)	2011	2012	2013	2014	2015E	2016E
Gasoline engines	210,560	245,346	256,050	209,126	209,126	209,126
Diesel engines	19,694	21,822	19,663	23,517	24,693	25,927
Xinchen brand engines	230,254	267,168	275,713	232,643	233,819	235,053
YoY change						
Gasoline engines	10.8%	16.5%	4.4%	(18.3%)	0.0%	0.0%
Diesel engines	32.9%	10.8%	(9.9%)	19.6%	5.0%	5.0%
Xinchen brand engines	12.4%	16.0%	3.2%	(15.6%)	0.5%	0.5%

Note: Engine unit sales data are from CAAM.
Source: Company data, CAAM, Macquarie Research, March 2015

Fig 15 Zhonghua's best selling model H330 carries a Xinchen engine



Source: Macquarie Research, March 2015

Fig 16 FAW Jilin Xenia (Senya) MPVs also use Xinchen engines



Source: Macquarie Research, March 2015

Valuation, recommendation, risks

Valuation is attractive and below auto sector average

Valuation is below auto sector average

Target price of HK\$4.50 based on 10x FY15E PER

Our target price of HK\$4.50 is based on 10x FY15E PER. The target valuation multiple is the same as the 10x we use for Brilliance as we believe Xinchen will continue to leverage its close strategic relationship with BBA, benefiting from BMW's success and high growth in China.

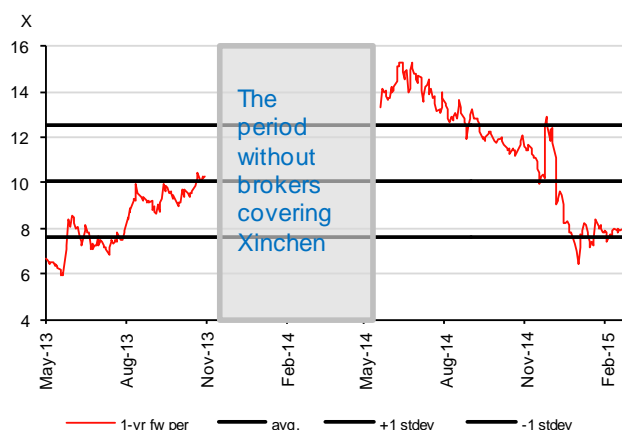
However, the 10x multiple is lower than the 12x we use for the auto parts company Huayu (Initiation report, [Standing on the shoulders of giants](#), January 2015). Reasons for the lower target valuation include:

- **Lack of diversified customer base:** Auto parts companies are generally trading on a 10-12x forward PER, a premium vs. carmakers in the global market, which are at 9-10x, because auto parts suppliers have a broader customer base, which mitigates the risk of the model cycle that OEMs have to face. However, Xinchen does not have a broad customer base; rather, it is highly reliant on its existing major customers and future growth prospects rest on BBA.
- **Lack of visibility beyond 2016:** The BMW contract details as currently disclosed are only up to 2016. We believe BMW will be evaluating Xinchen over the next two years before we can see more growth visibility for Xinchen beyond 2016.

High correlation on stock movement between Xinchen and Brilliance

Xinchen has been trading at an average of 10.2x since its listing in 2013. There were no brokers covering Xinchen until April 2014; therefore there is a blank period as shown in the forward PER charts below. In 2013, the stock trended higher as the potential of its BMW business was disclosed to the market. During 2014, the stock multiple trended lower partly because consensus expectations kept rising and partly because it moved in line with Brilliance's forward PER as show in Fig 18. There is a strong correlation in the stock price movements with an R-squared of 0.75 between Xinchen and Brilliance. This helps justifies our rationale of assigning same target valuation multiple to Xinchen and Brilliance.

Fig 17 Xinchen 12-m forward PER



Source: FactSet, Macquarie Research, March 2015

Fig 18 Xinchen PER moves in line with Brilliance



Source: FactSet, Macquarie Research, March 2015

Scenario analysis

We estimate the downside/upside to our earnings estimates and price target.

- **Bull-case:** A higher-than-expected utilisation rate of BBA transaction limitations would result in higher revenue contribution from BMW related revenue, which would also help to lift the overall GP margin. In the bull-case scenario, we also assume its own brand engines can grow 5% and 10% p.a. for gasoline and diesel engines, respectively.
 - ⇒ EPS would be 14%/12% higher than our base-case estimates in 2015E/16E, respectively;
 - ⇒ The stock trades at a higher valuation multiple of 12x, catching up with other auto parts companies. Valuation would be HK\$6.18 based on our estimates.
- **Bear-case:** A lower-than-expected utilisation rate of BBA transaction limits would result in a lower revenue contribution from BMW related revenue, which would also hurt overall GP margin expansion. In the bear-case scenario, we also assume its own brand engines face heightened competition, thus posting a 4.5% pa annual decline.
 - ⇒ EPS would be 20%/18% lower than our base-case estimates in 2015E/16E, respectively;
 - ⇒ We factor in a valuation de-rating for the company as investors see less exposure to the BMW business. On this scenario the valuation could remain low at HK\$2.90, which is roughly at the current level.

Fig 19 Scenario analysis on 2015-16E earnings

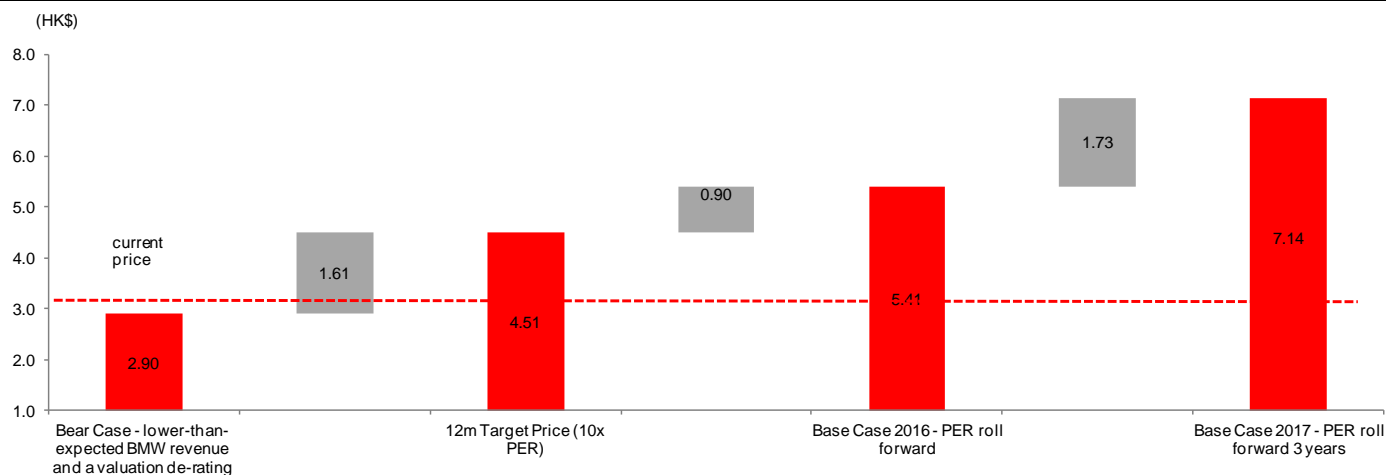
	2015E			2016E		
(m Rmb, except for EPS)	Bear	Base	Bull	Bear	Base	Bull
Key BMW assumptions						
Utilisation rate of BBA transaction limits	70%	85%	100%	85%	100%	115%
BMW related revenue	1,153	1,400	1,647	1,482	1,743	2,005
Own brand engines YoY						
Gasoline engines	(5%)	0%	5%	(5%)	0%	5%
Diesel engines	0%	5%	10%	0%	5%	10%
Own brand engines	(4.5%)	0.5%	5.5%	(4.5%)	0.5%	5.5%
Sales revenue	3,296	3,649	4,002	3,676	4,044	4,412
GPM	23.8%	24.9%	25.7%	25.2%	26.1%	26.8%
Gross profit	785	907	1,029	928	1,056	1,184
NPAT	371	462	527	454	554	619
EPS (Rmb)	0.29	0.36	0.41	0.35	0.43	0.48
EPS (HKD)	0.36	0.45	0.51	0.44	0.54	0.60
Vs. base-case	-20%		14%	-18%		12%
Target PER multiple (x)	8	10	12	8	10	12
Valuation (HKD)	2.90	4.50	6.18	3.55	5.41	7.25

Source: Company data, Macquarie Research, March 2015

Emerging Leaders Conviction Idea: The path to 100% upside

We add Xinchen Power to our Emerging Leaders Conviction List, and believe the stock price can double in three years' time, assuming BMW related revenue comes through as expected. As shown in Fig 20, if we roll forward our base case 10x PER multiple to 2017, the target price implies over 100% upside. Under our Bull case assumption as illustrated in the scenario analysis shown in Fig 19, the stock price could possibly double by 2016 if the BMW related revenue exceeds our expectation and the stock trades at a higher valuation multiple of 12x, in line with other auto parts companies.

Fig 20 Water flow chart: The path to 100% upside in 3 years



Source: Macquarie Research, March 2015

HK\$4.84 fair value using ROE-g/COE-g based on 2014-16E average

The fair value is HK\$4.84 using ROE-g/COE-g on our normalised 2014-16E estimates, close to our price target of HK\$4.50 based on 10x FY15E PER. As we expect 2015E to be a high growth year benefiting from the significant rising contribution from BMW related business, 2015E implied fair value is higher at HK\$5.31.

Fig 21 ROE-g/COE-g indicates fair value of HK\$4.84

		ROE 2015E	Normalised 3y ROE (2014-2016E)
Equity beta (b)		0.96	0.96
Risk-free rate (Rf) (%)	(%)	3.50%	3.50%
Equity risk premium (Rm-Rf) (%)	(%)	6.5%	6.5%
Cost of equity (Re = Rf+b(Rm-Rf)) (%)	(%)	9.7%	9.7%
ROE (%)	(%)	17.1%	15.6%
Perpetuity growth rate (%)	(%)	1.0%	1.0%
ROE-g (%)	(%)	16.1%	14.6%
COE-g (%)	(%)	8.7%	8.7%
Ratio (implied book value) (x)	(x)	1.85	1.68
BVPS (HK\$)	(HK\$)	2.87	2.88
Fair value (HK\$)	(HK\$)	\$5.31	\$4.84

Source: Company data, Bloomberg, Macquarie Research, March 2015

Macquarie estimates vs. consensus

Our earnings estimates are higher than consensus for 2014-15E, reflecting our confidence in the outlook for the contribution from the BMW-related business. In addition, we believe Xinchen's own brand engine business will be supported by the overall industry trend for smaller size and more efficient engines, thus maintaining stable to low growth.

Our current 2016E base-case estimates are lower than consensus although we have assumed a 100% utilisation rate of BBA transaction limitations. As highlighted in the scenario analysis Fig 19 and volume assumption for BMW engines business on page 5, there is upside to earnings should the new BMW engine capacity come on stream earlier than expected and transaction limitations be further lifted.

As of March 2015, Xinchen is covered by only 6 analysts, including 2 international brokers, due to its small market cap of US\$464m and relatively short listing history. We believe Xinchen will gain more market attention as it continues to leverage its BMW Brilliance relationship and deliver rising revenue from its BMW related business.

The Xinchen management team is based in Hong Kong and has regular communication with the investor community in Hong Kong and China.

Fig 22 Macquarie earnings estimates vs. consensus

(m Rmb)	Revenue	EBIT	Pre-tax profit	NPAT	EPS (Rmb)
2012A	2,573	364	342	290	0.31
2013A	2,586	335	324	271	0.22
2014E Macquarie	2,753	386	345	288	0.22
2014E Consensus	2,865	376	307	265	0.21
2015E Macquarie	3,649	630	553	462	0.36
2015E Consensus	3,965	549	449	380	0.30
2016E Macquarie	4,044	753	663	554	0.43
2016E Consensus	5,145	800	677	613	0.48

Source: Company data, Bloomberg, Macquarie Research, March 2015

Risks

Major risks include: a significant slowdown in China's auto market, lower-than-expected BMW-related revenue and a decline in Xinchen's own brand engine business.

A significant slowdown in auto demand: We expect China's auto demand will grow at 8-10% pa and premium brand growth should outpace the market growth through the end of the decade, driven by steady income growth. A hard landing or a significant slowdown in China's employment and wage growth could negatively impact auto sales and demand from Xinchen's OEM customers.

Less-than-expected BMW-related revenue: The BMW relationship and business is a key growth driver for Xinchen. Although BMW-related production is carefully monitored by seconded BMW engineers, there is execution risk should Xinchen be unable to deliver the high quality products required by BMW. This would result in lower-than-expected BMW-related revenue and also limit future cooperation opportunities with BMW.

A decline in Xinchen's own brand engine business: Xinchen's own brand engines are mainly supplied to domestic brand OEMs. We have seen a recovery in domestic brand OEMs' market share in recent months, primarily driven by low-priced SUVs, but competition remains intense. If Xinchen's main customers face a significant drop in their sales and Xinchen is unable to develop new business opportunities with other OEMs, there is a risk of a decline in Xinchen's own brand engine business.

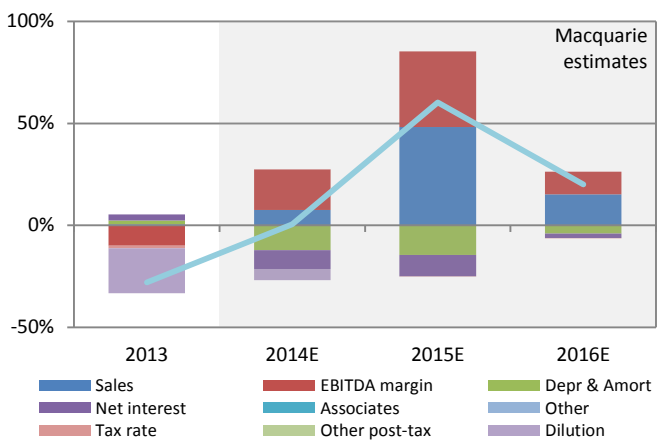
Fig 23 Comp sheet: auto OEMs and suppliers

Stock	Code	Rating	Mkt cap US\$m	Price (local)	TP (local)	+/-	FY1 P/E	FY2 P/E	FY1 P/B	FY2 P/B	
H-share Auto OEMs											
Great Wall-H	2333-HKG	Outperform	18,576	47.40	60.00	27%	14.4	9.8	3.5	2.8	
Brilliance	1114-HKG	Outperform	9,724	15.02	18.30	22%	10.4	9.4	3.3	2.5	
Dongfeng	489-HKG	Outperform	13,229	11.92	17.50	47%	7.6	6.1	1.1	1.0	
GAC-H	2238-HKG	Outperform	5,794	6.99	11.50	65%	7.6	5.6	1.0	0.9	
Geely	175-HKG	Neutral	4,081	3.60	3.50	-3%	12.2	10.7	1.5	1.3	
BYD-H	1211-HKG	Underperform	11,561	36.25	20.00	-45%	90.1	35.3	2.7	2.5	
BAIC Motor	1958-HKG	Not rated	8,149	8.32	NA	NA	7.5	5.7	1.2	1.1	
H-share Auto Parts											
Xinchen Power	1148-HKG	Outperform	464	2.80	4.50	61%	6.3	5.2	1.0	0.8	
Nexteer	1316-HKG	Outperform	2,542	7.90	9.25	17%	13.0	10.9	3.0	2.5	
Minth	425-HKG	Not rated	1,991	14.14	NA	NA	9.1	8.0	1.3	1.3	
Xinyi Glass	868-HKG	Not rated	2,314	4.58	NA	NA	8.4	6.8	1.3	1.2	
A-share Auto OEMs											
Changan-A	000625-CN	Outperform	15,138	20.29	25.00	23%	12.5	8.1	3.7	2.7	
Changan-B	200625-CN	Outperform	12,715	21.17	31.80	50%	10.5	6.8	3.1	2.3	
SAIC Motor	600104-CN	Outperform	44,315	25.12	30.00	19%	9.8	8.3	1.8	1.6	
Great Wall-A	601633-CN	Neutral	24,408	50.14	47.00	-6%	18.9	12.8	4.5	3.6	
BYD-A	002594-CN	Underperform	20,403	51.50	16.00	-69%	158.8	62.2	4.7	4.4	
GAC-A	601238-CN	Not rated	9,575	9.30	NA	NA	16.8	12.4	1.8	1.6	
Zhengzhou Yutong Bus	600066-CN	Not rated	6,204	27.81	NA	NA	16.8	14.1	3.3	3.0	
Jiangling Motor	200550-CN	Not rated	4,052	36.44	NA	NA	16.7	12.7	3.2	2.9	
FAW Car	000800-CN	Not rated	4,937	18.96	NA	NA	75.4	28.3	3.5	3.2	
Beiqi Foton	600166-CN	Not rated	3,340	7.43	NA	NA	49.4	19.9	1.4	1.3	
Anhui Jianghuai	600418-CN	Not rated	3,018	14.68	NA	NA	33.7	16.7	2.7	2.5	
Lifan	601777-CN	Not rated	2,246	11.16	NA	NA	26.7	19.9	1.9	1.7	
Haima	000572-CN	Not rated	1,650	6.27	NA	NA	29.9	23.8	1.4	1.3	
A-share Auto Parts											
Huayu	600741-CN	Outperform	8,262	19.99	22.60	13%	11.1	10.6	2.4	2.1	
Weifu High Tech	200581-CN	Not rated	4,268	32.48	NA	NA	20.4	15.1	3.2	2.9	
Fuyao Glass	600660-CN	Not rated	4,833	15.08	NA	NA	13.4	11.7	3.4	3.1	
Ningbo Joyson	600699-CN	Not rated	2,781	27.32	NA	NA	46.7	32.7	7.2	6.6	
Beijing WKW Automotive Parts	002662-CN	Not rated	1,890	15.75	NA	NA	30.9	19.7	2.9	2.6	
Winsan Shanghai Industrial Corp	600767-CN	Not rated	987	18.09	NA	NA	30.6	28.8	3.0	2.7	
FAWER Automotive Parts	000030-CN	Not rated	1,955	9.41	NA	NA	18.9	16.4	3.0	2.7	
Fengfan Stock	600482-CN	Not rated	1,476	17.19	NA	NA	58.9	45.5	4.5	4.1	
Songz Auto Air Conditioning	002454-CN	Not rated	1,219	18.79	NA	NA	26.8	21.1	3.4	3.1	
Faway Automotive Components	600742-CN	Not rated	1,136	33.58	NA	NA	13.8	11.1	2.1	1.9	
Asia-Pac Mechanical & Electronic	002284-CN	Not rated	1,075	18.22	NA	NA	35.1	27.6	2.8	2.5	
Xingyu Automotive Lighting	601799-CN	Not rated	945	24.64	NA	NA	22.4	18.6	3.1	2.8	
Global Auto OEMs											
Honda	7267 JP	Outperform	61,074	4,122	4,400	7%	13.3	10.9	1.2	1.1	
Nissan	7201 JP	Outperform	44,385	1,284	1,300	1%	12.6	10.2	1.2	1.1	
Toyota	7203 JP	Neutral	216,664	8,338	8,100	-3%	12.6	11.1	1.7	1.5	
Hyundai Motor	005380-KRX	Outperform	34,007	182,000	210,000	15%	5.5	5.3	0.9	0.8	
Kia Motors	270 KS	Outperform	17,144	47,350	56,000	18%	6.4	6.3	0.8	0.8	
Volkswagen	VOW3-DE	Not rated	127,358	252.45	NA	NA	10.3	9.2	1.2	1.1	
Daimler	DAI-DE	Not rated	104,046	91.71	NA	NA	12.6	11.4	1.9	1.7	
BMW	BMW-DE	Not rated	84,207	121.00	NA	NA	12.2	11.3	1.8	1.6	
Peugeot SA	UG-FR	Not rated	12,735	15.59	NA	NA	15.0	10.3	1.2	1.2	
Ford	F-US	Not rated	64,838	16.39	NA	NA	9.9	8.4	1.9	1.6	
General Motors	GM-US	Not rated	61,661	38.29	NA	NA	8.2	7.5	1.5	1.3	
Global Auto Parts											
Denso	6902 JP	Outperform	37,495	5,700	6,500	14%	16.1	14.8	1.5	1.4	
Toyota Industries	6201 JP	Outperform	18,176	6,970	7,800	12%	17.9	17.7	1.1	1.1	
Aisin Seiki	7259 JP	Outperform	10,302	4,415	5,200	18%	14.1	13.1	1.1	1.0	
Hyundai Mobis	012330-KRX	Outperform	21,919	258,500	350,000	35%	7.4	6.6	1.1	0.9	
Hyundai Wia	11210 KS	Outperform	3,553	151,000	190,000	26%	9.4	8.7	1.5	1.2	
Mando	204320 KS	Neutral	1,353	164,500	160,000	-3%	9.8	8.1	1.4	1.2	
Johnson Controls	JCH-US	Not rated	32,516	49.47	NA	NA	12.8	11.2	2.6	2.3	
Delphi	DLPH-US	Not rated	22,767	78.21	NA	NA	13.9	12.0	6.5	5.0	
BorgWarner	BWA-US	Not rated	13,457	59.43	NA	NA	16.4	13.9	3.1	2.7	
TRW Automotive	TRW-US	Not rated	12,042	104.74	NA	NA	12.9	11.9	2.3	2.0	
Autoliv	ALV-US	Not rated	10,082	113.66	NA	NA	16.8	14.6	2.9	2.7	
Osram Licht AG	OSR-DE	Not rated	4,967	44.79	NA	NA	18.4	15.2	1.9	1.8	
Honeywell	HON-US	Not rated	79,996	102.21	NA	NA	16.4	14.8	3.8	3.4	
Continental AG	CON-DE	Not rated	48,093	226.75	NA	NA	15.9	14.6	3.4	2.9	
Lear Corporation	LEA-US	Not rated	8,499	108.92	NA	NA	11.1	9.9	2.8	2.3	
Magna International	MG-CA	Not rated	21,617	134.53	NA	NA	10.8	9.3	2.4	2.1	
H-share Auto OEMs exclude BYD								10.4	8.3	2.1	1.7
A-share Auto OEMs exclude BYD								26.4	15.3	2.7	2.3
Global Auto OEMs								10.8	9.3	1.4	1.3
H-share Auto Parts								9.2	7.7	1.7	1.4
A-share Auto Parts								27.4	21.6	3.4	3.1
Global Auto Parts								13.8	12.3	2.5	2.1

Source: Wind for A-shares, FactSet for H-shares and global companies, Macquarie Research, March 2015; prices as of 17 March 2015 market close.

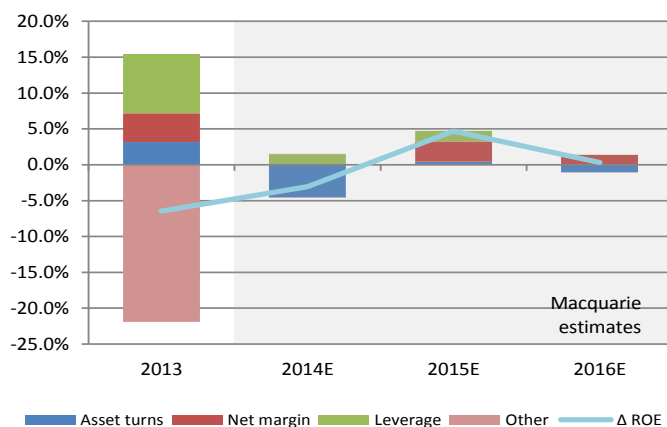
Appendix – Micro strategy charts

Fig 24 Earnings Analyser



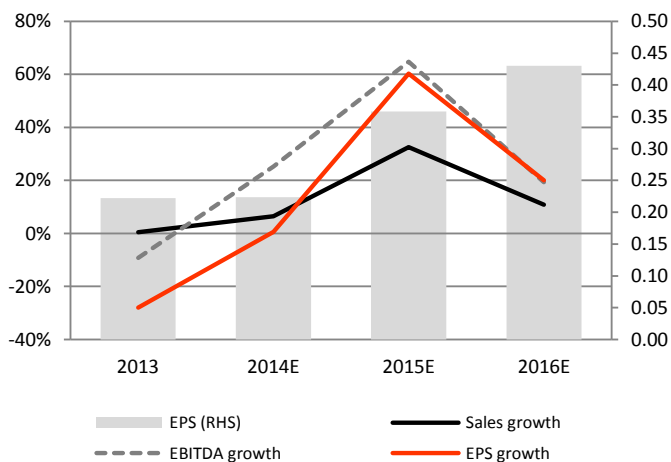
Source: FactSet, Macquarie Research, March 2015

Fig 25 ROE Analyser



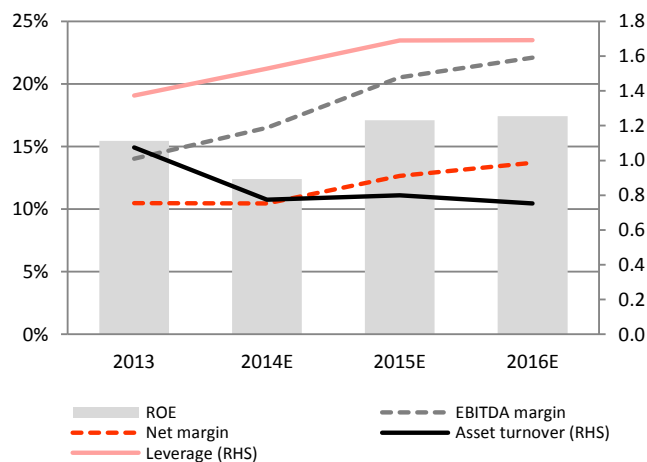
Source: FactSet, Macquarie Research, March 2015

Fig 26 Growth Analyser



Source: FactSet, Macquarie Research, March 2015

Fig 27 DuPont Analyser



Source: FactSet, Macquarie Research, March 2015

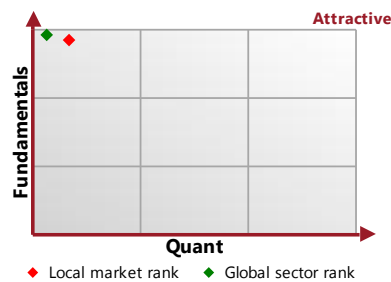
Macquarie Quant View

The quant model currently holds a strong negative view on Xinchen Power. The strongest style exposure is Valuations, indicating this stock is under-priced in the market relative to its peers. The weakest style exposure is Price Momentum, indicating this stock has had weak medium to long term returns which often persist into the future.

258/269

Global rank in
Automobiles & Components

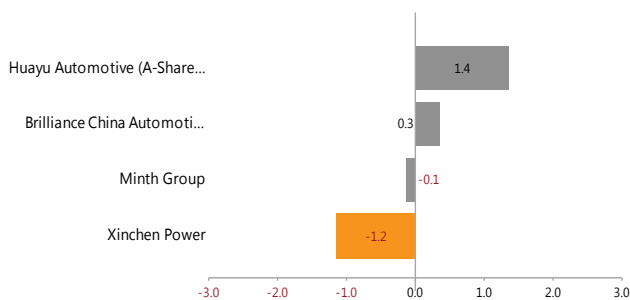
% of BUY recommendations 100% (3/3)
Number of Price Target downgrades 0
Number of Price Target upgrades 0



Displays where the company's ranked based on the fundamental consensus Price Target and Macquarie's Quantitative Alpha model. Two rankings: Local market (China) and Global sector (Automobiles & Components)

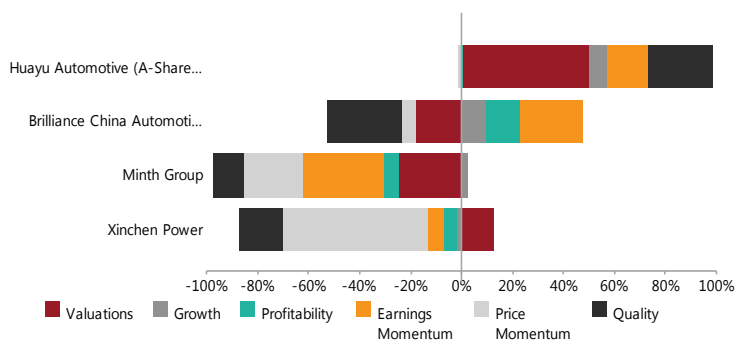
Macquarie Alpha Model ranking

A list of comparable companies and their Macquarie Alpha model score (higher is better).



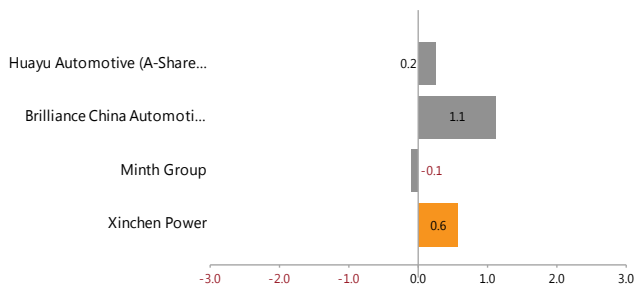
Factors driving the Alpha Model

For the comparable firms this chart shows the key underlying styles and their contribution to the current overall Alpha score.



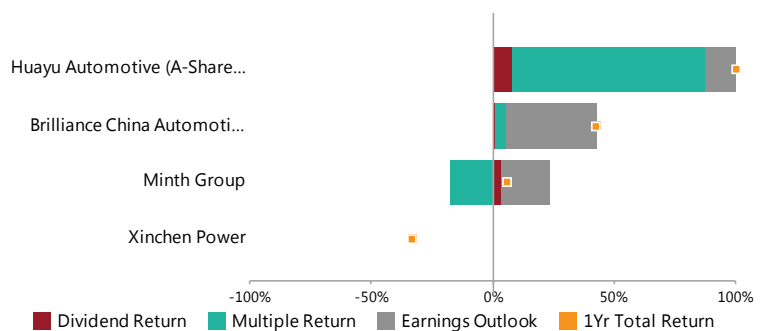
Macquarie Earnings Sentiment Indicator

The Macquarie Sentiment Indicator is an enhanced earnings revisions signal that favours analysts who have more timely and higher conviction revisions. Current score shown below.



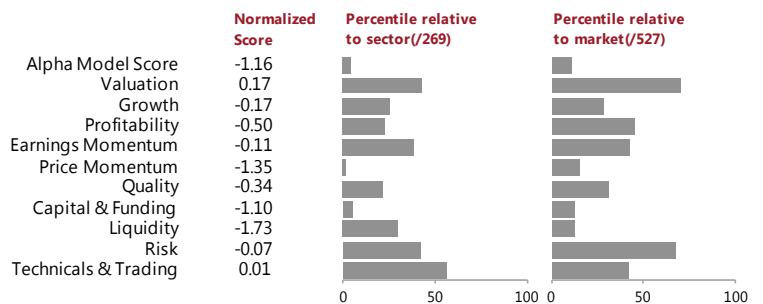
Drivers of Stock Return

Breakdown of 1 year total return (local currency) into returns from dividends, changes in forward earnings estimates and the resulting change in earnings multiple.



How it looks on the Alpha model

A more granular view of the underlying style scores that drive the alpha (higher is better) and the percentile rank relative to the sector and market.



Source (all charts): FactSet, Thomson Reuters, and Macquarie Research. For more details on the Macquarie Alpha model or for more customised analysis and screens, please contact the Macquarie Global Quantitative/Custom Products Group (cpq@macquarie.com)

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand

Outperform – return >3% in excess of benchmark return
 Neutral – return within 3% of benchmark return
 Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South - South Africa

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie - Canada

Outperform – return >5% in excess of benchmark return
 Neutral – return within 5% of benchmark return
 Underperform – return >5% below benchmark return

Macquarie - USA

Outperform (Buy) – return >5% in excess of Russell 3000 index return
 Neutral (Hold) – return within 5% of Russell 3000 index return
 Underperform (Sell) – return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high-highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low-medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Asia/Australian/NZ/Canada stocks only

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / epowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 31 December 2014

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	51.80%	58.06%	45.07%	44.42%	60.54%	46.81%	(for US coverage by MCUSA, 5.29% of stocks followed are investment banking clients)
Neutral	31.80%	27.37%	30.99%	50.10%	35.37%	33.51%	(for US coverage by MCUSA, 3.08% of stocks followed are investment banking clients)
Underperform	16.39%	14.57%	23.94%	5.48%	4.08%	19.68%	(for US coverage by MCUSA, 0.44% of stocks followed are investment banking clients)

1148 HK vs HSI, & rec history



(all figures in HKD currency unless noted)

Note: Recommendation timeline – if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, March 2015

12-month target price methodology

1148 HK: HK\$4.50 based on a PER methodology

Company-specific disclosures:

Important disclosure information regarding the subject companies covered in this report is available at www.macquarie.com/disclosures.

[Click here to enter text.](#)

Target price risk disclosures:

1148 HK: Any inability to compete successfully in their markets may harm the business. This could be a result of many factors which may include geographic mix and introduction of improved products or service offerings by competitors. The results of operations may be materially affected by global economic conditions generally, including conditions in financial markets. The company is exposed to market risks, such as changes in interest rates, foreign exchange rates and input prices. From time to time, the company will enter into transactions, including transactions in derivative instruments, to manage certain of these exposures.

Analyst certification:

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