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China high-end machinery sector***Moving to high-end and high quality***

*Under 12th Five-Year Plan, high-end machinery is one of the strategic industries. We believe domestic high-end machinery with high price-to-performance ratio will replace imported products. Driven by import replacement, demand for high-end machinery is strong. We are optimistic on this sector and **China High Precision (591 HK)** and **EVA (838 HK)** are our top picks.*

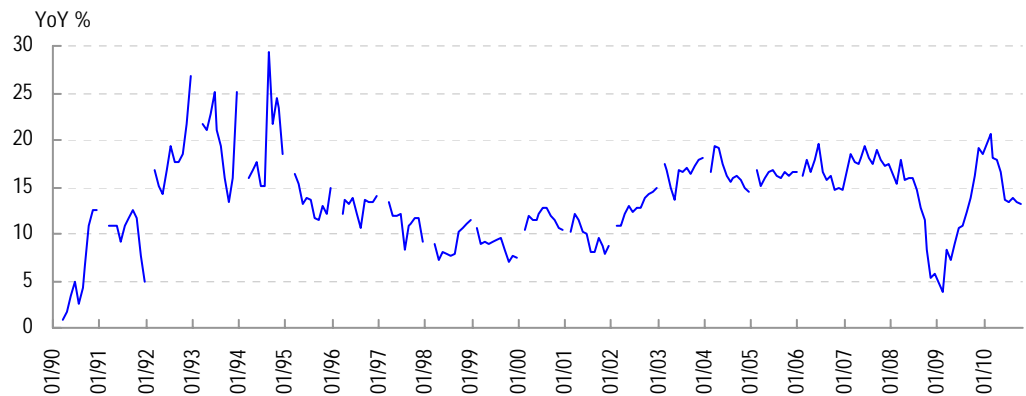
- ◆ **Slowing but still strong industrial production growth.** Industrial production in China has slowed from the peak in early 2010 to 13.1% in Oct, mainly due to high base level in 2H09. We expect the growth to continue to slow moderately, but we are still optimistic on Chinese economy and the industrial sector.
- ◆ **Strong demand for machinery.** Year to Oct, industrial production growth of machinery and equipment has outperformed the overall industrial production. Driven by robust demand for downstream products and consumer products, demand for machinery and equipment is strong.
- ◆ **Already dominant low-end market.** Chinese manufacturers have already dominated the low-end machinery and equipment market as they have a high price-to-performance ratio and low operating costs. However, competition between domestic players is keen and their profit margins are low.
- ◆ **Stepping into high-end and benefiting from 12th Five-Year Plan.** Encouraged by Chinese government, Chinese manufacturers try to step into high-end machinery and equipment. Under 12th Five-Year Plan, high-end machinery and equipment is one of the seven strategic industries. Rumor has it that enterprises in the seven strategic industries may enjoy 50% tax reduction, based on 15% corporate tax rate.
- ◆ **Affirmation of importance of high-end machinery and equipment.** In the 4th Annual Conference of Asian Manufacturing Forum in late Oct, Chinese officials reaffirmed the importance of high-end machinery and equipment. Manufacturing sector will upgrade from low-end to high-end in the future.
- ◆ **Import replacement.** Technology level in China still lags behind the overseas, especially for high-end equipments and precision instruments which still heavily rely on imports. But with improving technology and cost advantage, Chinese products will gradually replace imported high-end machinery. Riding on import replacement, we believe demand for high-end machinery is strong.
- ◆ **Top picks: China High Precision (591 HK) and EVA (838 HK).** In high-end machinery sector, China High Precision and EVA are our top picks as we are confident that they can capture market share from the overseas competitors.

Strong demand for machinery and equipment

Slowing but still strong industrial production growth. With low labor costs and low operating costs, China enjoys cost advantages over the western competitors. This allows China to become the largest manufacturing base in the global. During the past 2 decades, China has experienced a strong industrial production growth with an average growth level of 13.7%. Boosted by the government's stimulus economic measures, industrial production growth rebounded significantly from the trough in early 09. Due to high base level in 2H09, the yoy growth has slowed down to 13.1% in Oct. Although it is expected to continue decelerating in 1H11, the slowdown would be gradually instead of a sharp dip, we believe.

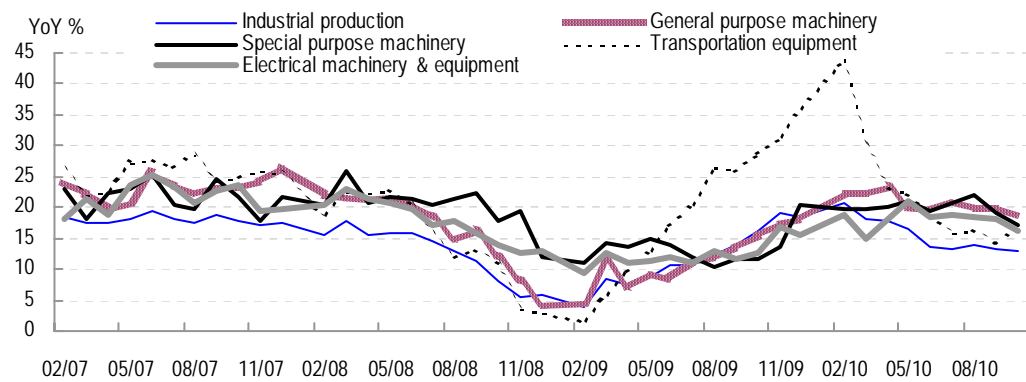
Strong demand for machinery. Year to Oct, industry production of general purpose machinery, special purpose machinery, transport equipment as well as electrical machinery & equipment grew 21.4%, 20.6%, 23.7% and 18.7%, respectively, outperformed the industrial production growth of 16.1%, as shown in Fig 2. During the financial tsunami, demand downturn resulted in suspension of many manufacturers' production. In the early stage of economic recovery, manufacturers were still cautious on expanding capacity and adding new machinery and equipment. As a result, except transportation equipment, others machinery and equipment sectors underperformed the market in 2H09. Nevertheless, rapid economic recovery is boosting downstream demand which in turn driving demand for machinery and equipment.

Figure 1: Strong industrial production growth



Source: Bloomberg

Figure 2: Value-added of machinery sector



Source: Bloomberg and CEIC

High-end leads the way

Already dominant low-end market. As low-end machinery market required relatively low technology, it is easy for Chinese manufacturers to develop. Having strong cost advantage, selling prices of Chinese machinery are much lower than the international prices. Thus, Chinese players usually could gain market share from the foreign players and finally kick them out of the low-end market in China. Yet, low-end market is usually fragmented with numerous domestic players and competition between them is fierce as industry entry barrier is relatively low. Profit margin is usually low.

Stepping into high-end and benefiting from 12th Five-Year Plan. Chinese government is striving to encourage manufacturers to upgrade technology level by tax reduction and government subsidies. To upgrade the manufacturing technology level, high-end machinery and equipment, which is one of the seven strategic industries under the 12th Five-Year Plan, is one of the critical points. It will directly affect the efficiency, productivity, safety, quality and technology level of other industries, such as nuclear, aerospace, military, mining, shipping, new materials, environmental engineering, and etc.

On 19 Nov, rumor has it that after “3-year exemption and 3-year half reduction”, enterprises in seven strategic industries may enjoy 50% tax reduction, based on 15% tax rate. This policy is waiting for approval of the State Council of the PRC, according to the local media.

Affirmation of importance of high-end machinery. Secretary of Ministry of Industry and Information Technology of the PRC, Zhang Xiangmu, affirmed in the 4th Annual Conference of Asian Manufacturing Forum that high-end machinery is core part among manufacturing industry chain. He estimates that by 2020, high-end machinery will account for >30% of machinery market, in term of sales value, and localization rate will reach >25%.

In the same Forum, vice head of the National People’s Congress Committee, Sang Guowei stated that technology level in China is still much lower than the overseas, especially for high-end equipments and precision instruments which still heavily rely on imports. We believe under the 12th Five-Year Plan, manufacturing industry will focus on innovation, technology upgrade and the high end development. Also, China is shifting from a labor intensive manufacturing into technology intensive manufacturing.

We believe nuclear equipment, railway equipment, coal machinery, machine tools and automation instrument will benefit from the government’s policy. **Dongfang Electric (1071 HK), Zhuzhou CSR Times (3898 HK), Sany (631 HK), IMM (1683 HK), ERA (8043 HK), Kunming Machine Tool (300 HK), Good Friend (2398 HK), China High Precision (591 HK), China Automation (569 HK) and Weichai Power (2338 HK)** are likely the beneficiaries.

Table 1: Some beneficiaries under 12th Five-Year Plan

Sectors	Stocks	Descriptions
Railway	Zhuzhou CSR Times (3898)	Supplier of train borne key electrical system and electric components
	China Automation (569)	Leading suppliers of safety and critical control system for petrochemical and railway in China
Nuclear equipment	Dongfang Electric (1072)	One of the largest suppliers of nuclear power equipment in China
Machine tools	Good Friend (2398)	CNC machine tool manufacturer
	Kunming Machine Tool (300)	One of the largest suppliers of milling and boring machine tools in China
Coal machinery	Sany (631)	Largest roadheader manufacturer in China
	IMM (1683)	Roadheader, shearer and armoured-face conveyor maker
	ERA (8043)	Top 3 supplier of hydraulic roof supports
Engine	Weichai Power (2338)	One of the largest diesel engine manufacturers in China
Instrument	China High Precision (591)	One of the largest high-end instrument manufacturer in China

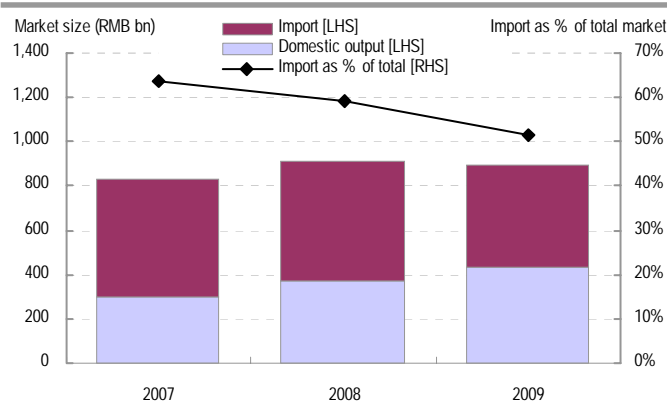
Source: company and Core Pacific-Yamaichi

Stock recommendations

Import replacement. Despite rapid development of technology, it is no doubt that Chinese technology level is still lagged behind the Western. Foreign players dominate high-end market with their advance technology but high selling prices. Due to a high price-to-performance ratio and improving technology, we do believe Chinese products are very competitive and import high-end products will be gradually replaced by domestic products. As illustrated in Fig 3, in the instrument market, proportion of imports declined from approximately 64% in 07 to 51% in 09. Worthy to note that in 09, output value of domestic instrument still recorded a 16% growth, while import value fell 15%, implying that domestic instrument manufacturers gained market share from imports. Process Automation Instrumentation Sub-Association of China Instruments Manufacturer's Association (PAISA) estimated that output value of domestic instrument would grow at a CAGR of 18% during 2009~2012.

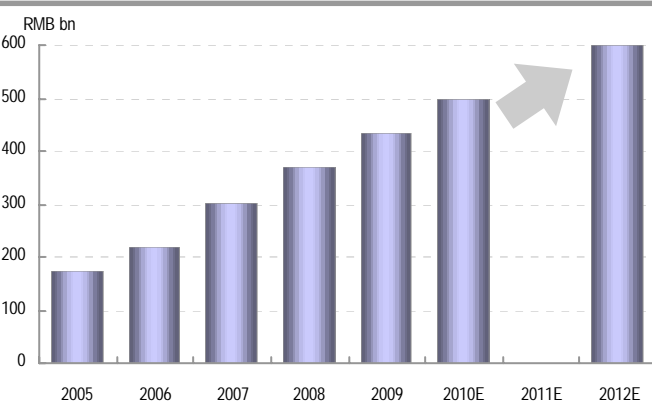
We believe demand for homegrown high-end product is strong and Chinese manufacturers are targeting on the high-end machinery market because competition in the high-end market is relatively low and products' profit margin is relatively high. However, not many players can do that. Riding on trends of import replacement, the high-end machinery and equipment manufacturers are the major beneficiaries and we are positive on their prospects.

Figure 3: Imports as % total instrument market size in China



Source: PAISA and the Customs of the PRC

Figure 4: Output value of domestic instrument



Source: PAISA

Top picks: China High Precision (591 HK) and EVA (838 HK). On the background of strong demand for domestic high-end machinery, two high-end machinery equipment manufacturers, China High Precision and EVA, are our top picks in this sector. There are some common points for them.

1. Focusing on high-end market only. China High Precision targets on high-end automation instrument market and EVA targets on high precious office automation equipment market.
2. Still small market share. Market share of China High Precision is less than 10% in the controller and indicator market, while that of EVA is less than 2% in the office automation equipment market. There is huge room for them to capture more market shares from their competitors.
3. Stable profit margin. As China High Precision produces high-end instruments, it has a strong bargaining power. For EVA, cost-plus pricing model allows it to enjoy a stable profit margin.