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CYD - Q1 2014 China Yuchai International Limited Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the China Yuchai International Limited first quarter 2014 earnings conference call. (Operator instructions). I must advise you that this conference is being recorded today, Monday, May 12, 2014.

I would like to now turn the conference over to Mr. Kevin Theiss. Please go ahead, sir.

Kevin Theiss - *Grayling - IR*

Thank you for joining us today and welcome to China Yuchai International Limited's first quarter 2014 conference call and webcast. My name is Kevin Theiss and I'm with Grayling, China Yuchai's US Investor Relations advisor. Joining us today are Mr. Weng Ming Hoh and Mr. Kok Ho Leong, President and Chief Financial Officer of CYI respectively. In addition, Mr. Kelvin Lai, VP of operations of CYI, is joining us today also.

Before we begin, I will remind all listeners that throughout this call we may make statements that may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words believe, expect, anticipate, project, targets, optimistic, intend, aim, will or similar expressions are intended to identify forward-looking statements. All statements other than statements of historical fact are statements that may be deemed forward-looking statements. These forward-looking statements are based on current expectations or beliefs including, but not limited to, statements concerning the Company's operations, financial performance and condition. The Company cautions that these statements, by their nature, involve risk and uncertainties and actual results may differ materially depending on a variety of important factors, including those discussed in the Company's reports filed with the Securities and Exchange Commission from time to time. The Company specifically disclaims any obligation to maintain or update the forward-looking information, whether of the nature contained in this release or otherwise, in the future.

Mr. Hoh will provide a brief overview and summary and then Mr. Leong will review the financial results for the first quarter ended March 31, 2014. Thereafter, we will conduct a question and answer session.

For the purposes of today's call, the financial results are unaudited and they will be presented in RMB and US dollars. All the financial information presented is reported using International Financial Reporting Standards as issued by the International Accounting Standards Board.

Mr. Hoh, please start your presentation.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Thank you, Kevin.

We are pleased to report that revenue increased 19.6% to RMB4.6b / $739.7m compared with RMB3.8b in the first quarter of 2013.

In the first quarter of 2014, our unit sales for both on- and off-road engines increased by 16.2% compared with a 4.4% increase in the unit sales of commercial vehicles, excluding petrol-powered vehicles, according data from the China Association of Automobile Manufacturers. The industry growth was led by a 20% gain in unit sales of heavy-duty trucks.

Our focus has always been to develop durable, high-quality engines with advanced technology and performance. By meeting or exceeding our customers' requirements, we further enhanced the reputation of our products. We remain committed to further developing our market share in the important heavy-duty truck sector.

We have expanded our truck engines to include a variety of diesel and natural gas models. All our heavy-duty engines are compliant with the latest emission standards and we have increased production over the past several years to serve our truck and bus customers.

We have upgraded our 6M model engines with 6K technology to the YC6MK six-cylinder engine and developed a natural gas version as well. Our next-generation YC6K six-cylinder diesel engine is already compliant with National IV and V emission standards with a capacity of between 10 to 13 liters. A natural gas version of this engine is now available. With heavy-duty engines requiring more technological improvements, we believe we have an opportunity to increase our market share.

In late April, 2014 China's Ministry for Industry and Information Technology published a directive that sales of National III vehicles are to cease by December 31, 2014. As a result, we believe that the pre-buy effect will continue to generate truck sales especially in the heavy-duty segment for the rest of 2014. The increasing implementation of strict emission standards across a great number of important cities such as Beijing, Shanghai, Guangzhou and Shenzhen is already causing a shift in production towards more National IV engines.

As one of the leading engine manufacturers of emissions technology in China, we have had the technology and production capability since 2008 to produce National IV engines on a commercial basis. And we have invested extensively in research and development to ensure that engines in our portfolio meet the current emission standards. We have also invested and developed National V emission standard engines as well as prototype engines complaint with National VI emission standards. We are well-positioned to offer a variety of National IV complaint engines to meet the needs of multiple markets and a series of gas engines compliant with National V emission standards as well.

During the first quarter of 2014 we sold close to 8,800 units of natural gas engines representing a 38.3% increase compared with the first quarter of 2013. Natural gas still is less expensive than diesel fuel and natural gas engine emit less pollutants compared with their diesel counterparts, making them ideal for urban use.

Our extensive experience with natural gas engines has enabled us to dominate the urban bus market and allows us to also serve the truck and off-road engine markets as use of natural gas gradually expands into more applications.

We continue to build our product portfolio of high-quality engines for the marine, construction, agriculture, mining and power generation markets. Of the eight new engines which have been launched in 2014, the YC6G series targets the loader market, the new diesel engine's model YC4FA series targets the hydraulic excavator market and the YC6CL engine has been launched for the marine and power generation market.

The remaining new engines are for the heavy-duty truck market, light-duty vehicles and the second-generation hybrid engine. Combined with the 12 new engines introduced in 2013, our expanded lines of advanced engines is setting a higher standard and positioning us for further growth. The construction of our new dedicated production facility for expanding lines of high horsepower engines is progressing and we anticipate that phase one construction will be completed by the end of 2014.

We maintain a strong financial position at March 31, 2014. And we have reduced our debt level as we continue building our production capabilities. Our expanded production facilities are generating cost savings through lower rejection rate, increasing economies of scale and Six Sigma lean manufacturing processes. With our growing production efficiency, financial strength, extensive product portfolio and service network in China, we are positioned to further improve our leadership in a number of markets within the industry. In view of our better performance over 2012, we have today announced a dividend of $1.20 per ordinary share for the financial year 2013 payable fully in cash or in new shares at the option of the shareholder.

With that, let me now turn the call over to Kok Ho Leong, our CFO, to provide more details on the financial results.

Kok Ho Leong - *China Yuchai International Ltd - CFO*

Thank you, Weng Ming.

Good morning and good evening. I will now provide some more details in the first quarter's financial performance. Our revenue for the first quarter of 2014 increased 19.6% to RMB4.6b ($739.7m) from RMB3.8b in the first quarter of 2013.

The total number of engines sold by GYMCL during the first quarter of 2014 was 151,909 units compared with 130,744 units in the same quarter of 2013, representing an increase of 21,165 units or 16.2%. This increase compares favorably with the industry growth of 4.4% in the sales of commercial vehicles excluding petrol-powered vehicles in the first quarter of 2014 as reported by the China Association of Automobile Manufacturers. This growth was mainly due to more engine sales for trucks and agriculture applications.

Gross profit was RMB788.4m / $128.1m compared with RMB737.2m in the first quarter of 2013. Gross margin decreased to 17.3% in the first quarter of 2014 compared with 19.4% a year ago. In the first quarter of 2014 lower gross margin was mainly attributable to a shift to a less profitable sales mix. More lower-margin units were sold, such as truck engines and light-duty engines including for agriculture applications.

Other income was RMB29.5m / $4.8m an increase of RMB8.6m from RMB20.9m in the first quarter of 2013. This increase was mainly due to a gain from foreign exchange revaluation.

Research and development -- R&D -- expenses increased by 10.6% to RMB104.9m / $17.1m from RMB94.9m in the first quarter of 2013. The increase was mainly due to development of new engines as well as continued initiatives to improve engine quality. As a percentage of revenue, R&D spending declined to 2.3% compared with 2.5% in the first quarter of 2013.

Selling, general and administrative, SG&A expenses were RMB366.2m / $59.5m up from RMB324.3m in the first quarter of 2013. SG&A expenses represented 8.0% of revenue compared with 8.5% in the same quarter a year ago.

Operating profit improved to RMB346.7m / $56.4m from RMB338.9m in the first quarter of 2013. The operating margin was 7.6% compared with 8.9% in the first quarter of 2013.

Finance costs increased to RMB37.8m / $6.1m from RMB34.2m in the first quarter of 2013, an increase of RMB3.6m or 10.5%. Higher finance costs mainly resulted from increased bill discounting at higher interest rates.

The share of joint ventures was a loss of RMB15.2m / $2.5m compared with a loss of RMB15.8m in the first quarter of 2013.

In the first quarter of 2014, total net profit attributable to China Yuchai's shareholders was [RMB180.0m] (corrected by company after the conference call) / $29.3m or earnings per share of RMB4.83 / $0.78 compared with RMB173.5m, or earnings per share of RMB4.66 in the same quarter in 2013.

Let me now go to the balance sheet highlights as at March 31, 2014. Cash and bank balances were RMB2.1b / $347.8m compared with RMB3.6b at the end of 2013. Short-term and long-term interest-bearing loans and borrowings were RMB1.9b, $314.4m, compared with RMB2.3b at the end of 2013. Inventories were RMB2.6b, $417.8m, compared with RMB2.3b at the end of 2013.

With that, operator, we are ready to begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mohit Khanna, Value Investment Principals.

Mohit Khanna - *Value Investment Principals - Analyst*

Hello, guys. I had a certain question regarding the outlook actually. You had said that the truck replacement cycle should help you gain the momentum throughout the year -- maintain the momentum throughout the year in truck sales. So could you please specify more on that?

Weng Ming Hoh - *China Yuchai International Ltd - President*

Okay. This is Weng Ming here, Mohit. If you look back at the history of diesel engine sales, I think the big year that we had was back in 2010 after the big stimulus package that was launched by the Chinese government. At that time, a lot of engines were sold.

So typically for a diesel engine like ours the replacement cycle is about five years. We're just coming to the end of the five-year period which ends in 2014/2015. That we believe will help us to sustain the sales for this year or the business for this year.

In addition, because the government has just announced the enforcement of the National IV engines from January 1, 2015, next year, we expect that there will be still some pre-buying from now to the end of the year, simply because the cost of a National III truck is cheaper than a National IV powered engine truck.

Mohit Khanna - *Value Investment Principals - Analyst*

Okay, okay. That's good. And could you please talk about little bit on how is the momentum going in the natural gas engines and what do you see going forward?

Weng Ming Hoh - *China Yuchai International Ltd - President*

Okay.

Mohit Khanna - *Value Investment Principals - Analyst*

Are more cities likely to adopt your engines?

Weng Ming Hoh - *China Yuchai International Ltd - President*

You mean the National IV engines?

Mohit Khanna - *Value Investment Principals - Analyst*

Yes.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Okay.

Mohit Khanna - *Value Investment Principals - Analyst*

National IV natural gas.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Natural gas engines, I think it's now widely sold in the big cities. And in fact it's doing very well. So far this year, in the first quarter of this year we sold about 8,800 units of natural gas engines. And that accounts for about 38% growth compared to the same period last year. We expect the momentum to continue this year to the end of the year. In fact, for the full year, we expect a very high growth rate for natural gas engines.

Mohit Khanna - *Value Investment Principals - Analyst*

Good. And also I had a question regarding the dividend and congratulations for the dividend increase. That's been very good. So the dividend now going forward would be $1.2 as a regular dividend?

Weng Ming Hoh - *China Yuchai International Ltd - President*

We do not have a dividend policy. It depends really on the performance of the Company each year and how much cash we need to retain for our working capital as well as any capital expenditure or investments that we may have, before we decide the level of dividend to pay out. So it will vary from year to year.

Mohit Khanna - *Value Investment Principals - Analyst*

So there's no any proper dividend policy or the payout target ratio that you guys model into?

Weng Ming Hoh - *China Yuchai International Ltd - President*

No, we do not have a formal dividend policy, no.

Mohit Khanna - *Value Investment Principals - Analyst*

Okay, okay. And another thing, on the balance sheet, as compared to the year-end 2013, cash looks a bit down. And on the other hand working capital, in the working capital, receivables has increased and payables has decreased. So all the unfavorable movement for the cash. So do you think this is not normal and this should be reversed in the second quarter?

Kok Ho Leong - *China Yuchai International Ltd - CFO*

I am Leong here. Let me answer that question. You're right that our cash balances has reduced by almost RMB1.4b, cash and bank balance reduced by RMB1.4b, and our trade and bills receivable increased correspondingly about RMB1.5b.

I think this you must look into the overall China money market situation. For the first quarter of 2014, I think it's known to all in the market that the China money market was tightened. And the interest rate had actually shot up somewhat in the first quarter, although at the beginning of the second quarter, we have seen the interest rate subsiding a little.

And tightening of money has resulted in us drawing on to our cash reserves so that we can minimize the interest costs. That's why you see, if you look at our interest, our increase in the interest is very modest compared to the volume of our business.

So if you ask me, I think this is proof of our financial strength, that we can draw on to our cash reserve when the time requires so.

As for you thinking will this be a long-term trend? Well, this is all depending on the market. If the money market is good, we will continue to borrow. Otherwise, we will conserve money as much as possible and draw from the reserves we have. I think that is the basic discipline that we always stick to.

Mohit Khanna - *Value Investment Principals - Analyst*

Fair enough, fair enough. And the final question on the gross margin. So could you just guide us a little bit on what should be the normalized level for the gross margins of the Company as now we have natural gas engines coming in and more models are expected to be launched soon? So what should be the normal gross margin for the Company going forward?

Kok Ho Leong - *China Yuchai International Ltd - CFO*

The gross margin that you see is a composite gross margin. As you know, we sell a variety of engines from light duty to heavy duty. And that further complicates by more and more product lines we have. In addition to our traditional diesel-powered engines, we now move to a hybrid, although it's not a big portion of us, but more and more there will be natural gas engines coming into play.

And not only that, the traditional National III engines will be slowly selling less and more National IV engines will be coming into play.

It's difficult for me to give a single-digit guidance on the gross margin because --

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Mohit Khanna - *Value Investment Principals - Analyst*

Well, a range as in how do you think this should affect coming in -- this should affect going forward the new hybrid engines coming in?

Kok Ho Leong - *China Yuchai International Ltd - CFO*

Yes. Going forward, as usual you can see our GP margin does move a little bit over the year. If you can go to our 20F, you can see the margin movement. Even at the last year, we clocked fairly comfortable margin at 20.5%. This quarter is a bit on the low side because we happened to sell more lower gross margin engines. For example, we sold more to the agricultural engines, yes, and also more light-duties that affect our margin in the mix.

Mohit Khanna - *Value Investment Principals - Analyst*

Okay. So probably 18% to 20% at the gross margin rate should be what we should target at going forward?

Kok Ho Leong - *China Yuchai International Ltd - CFO*

We would not give any forward numbers. The 20F may be a good guidance for you.

Weng Ming Hoh - *China Yuchai International Ltd - President*

It's Weng Ming here. Maybe I will give a little bit more guidance. The reason why we dropped to the current level of gross margin of about 17%-odd is because of the sales mix that we had. We're selling a lot more of lower level 4-cylinder engines to date this quarter, and less to what I call the bigger cc engine market, particularly in the bus segment.

So going forward, we expect the mix will improve but to what level I think -- I would guess we would have to wait and see. It should be better than what you see this quarter. That's the way we look at it.

Mohit Khanna - *Value Investment Principals - Analyst*

Okay. Fair enough, guys. Thank you so much.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Okay.

Operator

(Operator Instructions). Ke Chen, Shah Capital.

Ke Chen - *Shah Capital - Analyst*

Yes. It looked like you increased your market share as your growth is higher than the industry. Could you talk about the competition and the talk about the consolidation in the China truck and car and jeep business?

Weng Ming Hoh - *China Yuchai International Ltd - President*

No, I won't comment too much on the industry, but I can say from our own Company experience, overall our view of what we have seen in the first quarter for ourselves. Now this is really the first quarter and we saw growth in the heavy-duty truck market. The growth was quite significant. The growth was a carry-on from the previous year as well in which we saw quite a fair bit of growth there.

This year we have also seen quite good growth in the agriculture segment of our business. This is where the bulk of our growth came from. Now the other segments like the marine had also registered some growth but the industrial segment of our business has actually not done so well this quarter.

And the overall bus market segment has not grown as much as we had anticipated. In fact, in certain parts of the bus market, it has actually registered a decline for the first quarter compared to last year.

Now, going forward how this will affect the industry, it's hard to say but we believe that the heavy-duty segment will continue to grow this year largely because of the pre-buy effect and we believe will continue to see some growth in the heavy-duty segment. And recent government incentives on the agricultural machinery will also help to sustain that part of -- that segment of the business.

Ke Chen - *Shah Capital - Analyst*

Okay. And Cummins was very positive on their China business on their recent earning call. Do you feel the same way going forward?

Weng Ming Hoh - *China Yuchai International Ltd - President*

Well, I can't comment on Cummins or other competitors. What we think will happen, as I said earlier, is that we do expect the heavy-duty truck market to continue to grow this year and the agriculture segment to grow this year. So we think that, from our own angle, we will see growth in these two segments of our business.

Weng Ming Hoh - *China Yuchai International Ltd - President*

We will take a question from the webcast. This question is what is the gas engines sales outlook for the rest of 2014?

It's hard to say how the industry is going to end up this year, but for our case, we expect the growth to be quite significant this year compared to last year. So far this year in the first quarter we have grown 38%. So for the rest of the year, we will still expect a significant growth either it could be a little bit less, it could be a little bit more. So it would still be a very significant growth for us this year.

Another question is, are you planning to have your Investor Day in Q2 or Q3?

We have not decided on the timing yet, on the Investor Day. Once we have decided and have a plan for it, we will inform those people who are interested to attend.

Operator

(Operator Instructions). [Nick Zhu], JPMorgan.

Nick Zhu - *JPMorgan - Analyst*

Hi, guys. Thanks for taking my question. Three questions from me. First, what is the percentage of truck engines sold during the first quarter this year that is coming from China IV-compliant engines and how does it compare to the ratio in 2013?

My second question is that you guys mentioned that replacement demand for trucks is going to be strong for the rest of the year plus increasing pre-buying demand ahead of the enforcement of China IV emission standard. So overall speaking what's the overall growth rate that you are looking for at the industry level for heavy-duty trucks?

The third question, I think someone probably asked, but can you just comment a little bit on how the truck makers' effort in vertical integration will impact on independent engine producers like us. Thanks.

Weng Ming Hoh - *China Yuchai International Ltd - President*

I got two of the questions and you mentioned three, I got two. One is the industrial growth that you asked about earlier. The industrial -- from the statistics it seems the industry actually grew by about 20% in heavy-duty trucks. So now this is still quite a significant growth.

Now how is it going to end up this year, what growth rate it's going to end up this year, honestly we have to guess. But from my point of view I think that the growth is going to continue, especially because of the enforcement of National IV standards by the beginning of next year. That will still drive some pre-buying activities for the second half of this year.

Now, although the government has implemented the National IV standard from July 1 last year, not all cities have enforced it. Even up to today, although there are quite a number of cities that are enforcing these standards, there are still many cities which have not enforced the standard. So, it will still continue to have an impact in driving the sales of the heavy-duty trucks this year I think.

The other question is on vertical integration. Yes, there are some OEMs who are now thinking of building their own engine plant, but I think from our point of view, we will continue to be an independent engine manufacturer. We believe that this is probably a very strong competitive edge, an advantage for ourselves simply because we do not compete with our customers. So that in itself, is a very strong competitive edge compared to our competitors.

Nick Zhu - *JPMorgan - Analyst*

Okay, thanks.

Operator

Jeremy Tan, Harvest Global.

Jeremy Tan - *Harvest Global Investments - Analyst*

Hi. Thanks for taking the question. Could you comment a little bit on the competition of your products and also the competition in the market.

Second question is, I think the nationwide implementation of this National IV engine will be by January 2015. So do you think that, given that you are saying that most cities have not enforced this standard, do you think that there will be acceleration going into 2015? Thank you.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Thank you. I am afraid we do not comment on our competitors and their pricing and I think it is very difficult to actually talk about it in the conference call.

Now as for the National IV enforcement from January 1, 2015, I personally think that it will continue to drive what I call the sale of the heavy-duty truck especially this year. And I think that growth will still be quite significant especially because the cost of a new truck is so much more than the National III engine truck.

Operator

There are no further questions at this time. I would now like to hand the conference back to Mr. Kevin Theiss. Please continue.

Kevin Theiss - *Grayling - IR*

Thank you all for participating in our 2014 first quarter conference call. We look forward to speaking with you again. Good bye and have a good day.

Weng Ming Hoh - *China Yuchai International Ltd - President*

Thank you all.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for your participation. You may all disconnect.