

Analyst: Paul Sham

Main Board Listing – Research

重慶機電股份有限公司

Chongqing Machinery & Electric Co., Ltd [Stock Code: 02722]
Sole Global Coordinator, Sole Bookrunner, Sole Lead Manager and Sole Sponsor : Credit Suisse (Hong Kong) Limited

Sector : Industrials, Capital Goods

Business : Manufacturing vehicle parts & components, power equipment, general machinery and CNC machine tools

Total share offer: <u>*1,004,900,000</u> shares (27.27% of the enlarged share capital) Public Offer: 100,492,000 shares (10%) Placing: 904,408,000 shares (90%) Greenshoe: 150,735,000 shares <i>*All 1,004,900,000 shares are New Shares</i>	<u>Business of Chongqing Machinery & Electric (CQME)</u> CQME is the largest industrial conglomerate in Western China in terms of total revenue, totalling RMB4,284m in 2006, according to the China Industrial Enterprise Yearbook. Based in Chongqing, It engages in the design, manufacture and sale of a variety of products in the mainland which includes:- <i>Commercial vehicle parts and componenets (26% of group turnover):</i> Mainly for medium- to over-sized commercial industrial vehicles such as trucks, buses, mining vehicles, specialty vehicles and marin vessels or power generation units for industrial and residential buildings. <i>Power equipment (37% of group turnover):</i> Primarily used in power generation, transmission and distribution. <i>General machinery (18% of group turnover):</i> For a wide range of industries, including metallurgical, oil and gas, environmental protection, electricity, nuclear power, pharmaceutical, chemical, food, aeronautic and astronautic industries. <i>CNC (Computer Numerical Control) machine tools (19% of group turnover):</i> Used in automotive, machinery, ship building, aeronautic and astronautic, energy and electric industries.
Price: HK\$1.30 – HK\$1.70 per share Market Cap: HK\$4,790 million – HK\$6,264 million Fully diluted FY07 PER: 9.6x – 12.5x Adjusted NTA per share: HK\$0.85 – HK\$0.97 Staffing: 15,444 (as of 31 st December 2007)	
HK Public Offer period: 30 th May 2008 – 4 th June 2008 Receiving banks: Bank of Communications Co., Ltd. HK Branch ICBC (Asia) Limited Share registrar: Computershare Hong Kong Investor Services Ltd. Listing date: 13 th June 2008	

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**Shareholding Structure after Listing** (Assuming the over-allotment option is not exercised)

Chongqing Machinery and Electronic Holding (Group) Co., Ltd. – owned by Chongqing SASAC*	52.22%
Chongqing Yufu Assets Management Co., Ltd – owned by Chongqing SASAC	6.30%
Chongqing Jiangong Group Co., Ltd. – owned by Chongqing SASAC	6.30%
China Huarong Asset Management Corporation	5.32%
The National Council for Social Security Fund of the PRC	2.59%
Public Investors	27.27%
	100.00%

Remark: (*)SASAC - State-owned Assets Supervision and Administration Commission

Use of Proceeds

Net proceeds from the offer are estimated to be HK\$1,307 million (Assuming the over-allotment option is not exercised, and at an issue price of HK\$1.50 each, being the midpoint of the indicative price range)

	HK\$ million
For the investment in commercial vehicle parts & components segment	281
For the investment in power equipment segment	222
For the investment in general machinery segment	199
For the investment in CNC machine tools segment	167
For the acquisition of companies or products	327
For working capital and general corporate purposes	111

Financial Highlights

	Year ended 31 st December		
	2005	2006	2007
	<u>RMB millions</u>	<u>RMB millions</u>	<u>RMB millions</u>
Revenue	3,089.9	4,284.2	5,485.5
Gross profit	689.0	866.5	967.6
Operating profit	433.0	356.7	435.4
Attributable profit	381.0	302.0	450.0
Gross margin	22.3%	20.2%	17.6%
Operating margin	14.0%	8.3%	7.9%
Net margin	12.3%	7.0%	8.2%

Revenue Breakdown by product (% of Total Revenues)

	Year ended 31 st December					
	2005		2006		2007	
	<u>RMB millions</u>	%	<u>RMB millions</u>	%	<u>RMB millions</u>	%
Commercial vehicles parts & components	905.0	29.3	1,122.5	26.2	1,420.0	25.8
Power equipment	1,016.8	32.9	1,533.5	35.8	2,012.0	36.7
General machinery	670.8	21.7	856.4	20.0	1,008.3	18.4
CNC machine tools	497.3	16.1	771.8	18.0	1,045.2	19.1
Total	3,089.9	100.0	4,284.2	100.0	5,485.5	100.0



Strengths/Opportunities

- ✓ **Diversified product portfolio** With a balanced weight among the 4 business segments (namely, vehicle parts, power equipment, general equipment & computer numeric control), CQME has a well-diversified product mix, catering customers in different industries, which enables CQME to benefit from different growth opportunities presented by a broad spectrum of markets. Most importantly, diversification in its product portfolio allows CQME to manage market fluctuations in individual market sectors and lower its operational risks.
- ✓ **Healthy growth momentum** CQME reported balanced revenue growth. Its revenue grew at a CAGR of 33%, from 2005 to 2007, while all 4 business segments posted CAGR of 23%-45% during the same period, suggesting CQME experienced an all-rounded development. In addition, we believe the demand for machinery equipment is still on the rise in the near future due to rising urbanization and industrialization.
- ✓ **Favourable “Go-West” policy** Introduced in 1999, the policy aims at addressing the imbalance between the more wealthy coastal regions and the less developed western regions. From 2000 to 2004, the PRC government spent RMB850 billion on various infrastructure projects in order to attract more investments to that part of the country. Such “Go-West” policy provides a favourable opportunity for CQME to develop the market presence throughout China.
- ✓ **Fair valuation** There is no similar HK listed companies comparable to CQME’s profile. Based on the selected companies in the machinery sector, Shanghai Electric (02727.HK), Dongfang Electric (01072.HK), Harbin Power (01133.HK) are trading at an average FY07PE of 11.9x. CQME’s 9.6x to 12.5x fully diluted FY07PE seems not too demanding.

Weaknesses/Threats

- × **Rising raw material cost squeezed the profit margin** Even though CQME shows an upward revenue trend from 2005 to 2007, the gross margins were under raw material cost pressure. Affected by the steep increase in raw material costs, both CNC machine tools and power equipment segments posted the largest drop in gross profit margins, from 32% and 14.1% in 2005, to 19.8% and 8% in 2007, respectively, resulting in narrowing of the overall gross margin from 22.3% to 17.6% in the same period.
- × **Undetermined impact from the recent earthquake** Wenchuan County of Sichuan Province, a region that is approximately 360km away from Chongqing City, suffered an earthquake with an 8.0 magnitude on the Richter Scale. Despite CQME reported that it has not suffered from any material damages so far, we believe its productivity and profitability might still be adversely affected, at least to a certain extent, due to unidentified personal injury & facility damage.

Recommendation: Subscribe



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