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CYD - Q3 2013 China Yuchai International Limited Earnings Conference Call

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CONFERENCE CALL PARTICIPANTS

Alex Potter *Piper Jaffray - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. And welcome to the China Yuchai International Limited third quarter 2013 earnings conference call. (Operator Instructions).

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

Kevin Theiss - *Grayling - IR*

Thank you for joining us today. And welcome to China Yuchai International Limited's third quarter and nine-months end of September 30, 2013 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 also joining us today.

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, the statements concerning the Company's operations, financial performance and condition.

The Company cautions that these statements by their nature involve risks 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 conference call and 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 third quarter and first nine months end of September 30, 2013. 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 Limited - President*

Thank you, Kevin. We are excited to report that we achieved the highest revenues in any third quarter in the Company's history. Net revenue for the third quarter 2013 increased 21.6% to RMB3.7b or $608.7m from RMB3.1b in the third quarter of 2012. Our gross margin was maintained at 20.9% in the third quarter, which was the result of higher sales volume.

According to data from the China Association of Automobile Manufacturers, overall commercial vehicle sales in the third quarter of 2013 rose by 9.3% and were led by a 13.2% increase in heavy-duty truck sales. Truck sales benefited primarily from the continued pre-buying of trucks in the third quarter of 2013 and inventory restocking to meet future demand.

We continued to increase our leading market position as our diesel unit sales rose by 21.5% year over year, exceeding industry growth.

We are optimistic over the long-term growth prospects in the heavy-duty truck segment and we believe that our strategy to expand our production capacity and develop new engines to improve our market position in the heavy-duty truck market provides us with a growth opportunity for the future.

While the National IV emission standards were implemented nationwide on July 1, 2013, we have been producing engines complying with National IV and V emission standards much earlier. By selling advanced engines meeting the new more stringent emission standards before our competitors, we are able to capture market share with our first-to-market strategy and raised technology bar (inaudible).

Our vast research and development program is designed to make us an innovative leader in China to accommodate the changing technological requirements of our customers. Innovation is critical to provision the Company for future growth and market leadership.

We are developing new high horsepower engines for power generation, marine, mining and other industrial applications in order to reach new customers and further capture market share in these markets. One of our focus is on the marine market due to growing demand for recreational boats and leisure craft. We have been successful in penetrating this market with our lineup of low-speed, medium-speed and high-speed marine engines.

In the third quarter 2013, we announced the release of our latest high-speed engine models YC4S, YC4B, YC6A, YC5L, YC6MK, YC6MJ and YC6B for both (background noise).

To complement our traditional diesel engine portfolio, a complete line of natural gas engines have been introduced as they provide economical and environmental advantages to our customers. In the first nine months of 2013, sales of our natural gas engines continued to grow and approximately 31,000 natural gas engines have been sold, thus representing a substantial increase compared with the same period last year when approximately 13,000 engines were sold.

Our natural gas engines, which are compliant with National IV emission standards, is a key factor for our dominant position in China's vast market.

Our new Research and Development Institute located in the High-Tech Development Zone of Nanning, the capital of Guangxi Province, which commenced operations in [October] 2013 will be a new catalyst for further innovation.

Additionally, our joint venture with key partners adds to our technology base for new engine design and advanced industrial knowledge. For example, our joint venture (technical difficulty) engines YC6K six-cylinder 12L series of engines recently received the European Union's E-Mark certification due to the new technology included in this design. As our technology base grows, it builds up our ability to quickly anticipate change and design engines for the future.

Let me now touch on some developments that occurred in the third quarter. We remain committed to becoming one of China's leading heavy-duty engine manufacturers. The market for heavy-duty engines has accelerated over the past three quarters, which provides us with a number of long-term opportunities.

Our YC6K engine is the basis of a number of new diesel and natural gas engines we offer with strong performance, low emissions and improved fuel efficiency. The YC6K designed engines are part of our family of heavy-duty engines, including the 6L, 6M, 6G and our enhanced 6MK heavy-duty engine.

During the third quarter of 2013, Dalian Public Transport Group Tourism Branch use our engines in 80% of its fleet of approximately 80 buses. The YC6M and YC6MK engines are now preferred engines for use due to their sheer power and fuel efficiency.

Our main operating subsidiary, GYMCL and GYMCL's joint venture entity Y&C Engine Company Limited, entered into a (inaudible) joint venture with Baotou Beifang Chuangye Company, a company listed on the Shanghai Stock Exchange and Baotou Bei Ben Heavy Duty Truck Company. The new joint venture will produce advanced diesel and gas engines to meet the need for Baotou Bei Ben's heavy-duty and medium-duty trucks and buses. GYMCL and Y&C Power will hold, together hold 50% of the joint venture.

We are excited over the prospect of this new venture as it allows us another avenue to expand our heavy-duty engine capabilities and increase market share in these two (inaudible) segments.

In the first nine months of 2013 ended September 30, we maintained our market leadership as we sold 390,000 engines, a 15.3% increase over the same period in 2012. With a more diverse range of advanced engines and new production capacity been added, we are targeting to capture additional market share in the on-road and off-road markets in China. I'm pleased to update that we sold 41,000 engines in the month of October this year.

In the first nine months of 2013, we generated positive cash flow from operating activities and we continued to invest in property, plant and equipment such as adding capacity for natural gas and high-horsepower engines as well as upgrading our foundry capabilities. By investing in building high-quality, advanced products, we can improve our market position, thus creating long-term value for our shareholders.

To share our success with our shareholders, we paid an interim $0.10 cash dividend for ordinary shares to the shareholders on August 26, 2013. We believe that the payment of dividends is the best way to reward our shareholders.

We continued to expand our market share in the third quarter of 2013 and maintain a leading position in the world's largest commercial vehicle engine market. Entering into the fourth quarter 2013, we remain cautiously optimistic as while the market for commercial vehicles has improved, uncertainty remains over the Chinese economy.

However, I believe that we are well positioned to take on the challenges ahead with our strong OEM relationships, the largest service network in China, a diverse and growing platform of advanced diesel and natural gas engines to address multiple engine markets and sound financial strength].

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 Limited - CFO*

Thank you, Weng Ming. Let me first walk you through our unaudited third quarter and first nine months ended September 30, 2013 financial results and then we can begin the Q&A session. Net revenue for the third quarter of 2013 was RMB3.7b, $608.7m, which is the highest revenue achieved in any third quarter in the Company's history compared with RMB3.1b in the third quarter of 2012. The increase in net sales was RMB665.5m or 31.6% as compared with the same period in 2012.

The total number of diesel engines sold during the third quarter of 2013 was 118,282 engines compared with 97,328 units in the same quarter a year ago, consequently, an increase of 20,954 units or 31.5%. This was mainly attributable to an increase in the sales of engines to the truck market and for agriculture applications.

Truck sales benefited primarily from the continued pre-buying of trucks in the third quarter of 2013 and inventory restocking to meet future demand. Sales of diesel-powered commercial vehicles grew by 5.3% year over year in the third quarter of 2013, led by 12.8% growth in the heavy-duty trucks compared to same period in 2012.

Gross profit increased 25.7% to RMB781.5m, $127.1m, compared with RMB621.5m in the same quarter of 2012. Gross margin was 20.9% in the third the quarter of 2013 compared with 20.2% in the same quarter last year. The higher sales volume in the third quarter of 2013 compared with the same period a year ago resulted from better economies of scale which contributed to the higher gross margin.

Other operating income was RMB28.9m, $4.7m, a decrease of RMB11.8m from RMB40.7m in the same quarter last year. The decrease was mainly due to foreign exchange revaluation losses, as compared to a gain in foreign exchange revaluation in the same quarter in 2012.

Research and development, R&D, expenses were RMB111.6m, $18.2m compared with RMB93.9m in the same quarter of 2012, an increase of 18.9%. As a percentage of net revenue, R&D spending was 3.0% compared with 3.1% in the same quarter of 2012.

Selling, general & administrative, SG&A expenses were RMB446.0m, $72.5m, up from RMB353.1m in the third quarter last year, an increase of RMB92.9m or 26.3%. SG&A expenses represented 11.9% of the net revenue compared with 11.5% in the third quarter of 2012. The increase in the SG&A percentage was mainly due to higher warranty charges and provision for doubtful debts associated with increased sales in the third quarter. The lower provision for doubtful debt in the third quarter last year was attributed to a reversal of the provision upon successful collection.

Operating profit increased by 17.4% to RMB252.8m, $41.1m, from RMB215.2m in the third quarter of 2012, mainly due to higher gross profit partially offset by higher SG&A and R&D expenses. The operating margin was 6.8% compared with 7.0% in the third quarter of 2012.

Finance costs increased to RMB61.6m, $10.0m, from RMB28.7m in the same quarter last year, an increase of RMB32.9m. Higher finance costs mainly resulted from increased bills discounting at higher interest rates compared with the same period in 2012.

The share of joint ventures was a loss of RMB7.2m, $1.2m, compared with a loss of RMB8.3m in the same quarter last year.

In the third quarter of 2013, total net profit attributable to China Yuchai's shareholders was RMB106.5m, $17.3m, or earnings per share of RMB2.86m, $0.46, compared with RMB111.1m or earnings per share of RMB2.98 in the same quarter in 2012.

I will now move on to the financial results for the nine months ended September 30, 2013. Net revenue was RMB11.8b, $1.9b, compared with RMB10.2b in the same period last year. The increase in the net sales was RMB1.7b or 16.2% as compared with the same period 2012.

The total number of diesel engines sold by GYMCL during the first nine months of 2013 was 390,173m compared with 338,354 units in the same period last year, representing an increase of 51,819 units or 15.3%. This increase was mainly attributable to an increase in the sales of engines to the truck market and for agricultural applications.

Gross profit was RMB2.4b, $392.6m, compared with RMB2.1b in the same period last year, reflecting a 16.3% increase. Gross profit margin remained at 20.4% for the first nine months of 2013 and 2012.

Other operating income was RMB86.4m, $14.1m, an increase of RMB8.0m from RMB78.4m in the same period last year.

Research and development, R&D, expenses were RMB322.3m, $52.4m, compared with RMB271.0m in the same period in 2012, an increase of 18.9%. As a percentage of net revenue, R&D spending was 2.7%, which was the same compared with the first nine months of 2012. The R&D expenses related mainly to the ongoing research and development of new and existing engine products, as well as continued initiatives to improve engine quality.

Selling, general & administrative SG&A expenses were RMB1.3b, $203.7m, up from RMB1.1b in the same period last year, an increase of RMB0.2b or 12.9%. SG&A expenses represented 10.6% of net revenue for the first nine months of 2013, compared with 10.9% in the same period last year. The decrease was mainly due to higher sales in the first nine months of 2013, as compared with the same period in 2012.

Operating profit increased 19.8% to RMB925.4m $150.5m, from RMB772.5m in the same period last year, mainly due to an increase in gross profit and other income, partially offset by higher R&D and SG&A expenses. The operating margin was 7.8%, compared with 7.6% in the same period last year.

Finance costs declined to RMB135.4m, $22.0m, from RMB166.2m in the same period last year, a decrease of RMB30.8m or 18.5%. The decline in finance cost was mainly due to lower interest costs from the outstanding short-term and medium-term notes and less bills discounting in the first half of 2013, as compared with the same period in 2012. This saving was partially offset by higher finance costs in the third quarter of 2013.

The share of joint ventures was a loss of RMB32.9m, $5.4m, compared with a loss of RMB31.2m in the same period in 2012.

For the nine months ended September 30, 2013, total net profit attributable to China Yuchai's shareholders increased 28.9% to RMB446.3m, $72.6m, or earnings per share of RMB11.98, $1.95, compared with RMB346.1m or earnings per share of RMB9.29 in the same period last year.

I shall highlight a few key items in the balance sheet as at September this year 2013. Cash and bank balances were maintained at RMB3.2b, $527.7m, which was the same as at December 31, 2012. Short and long-term borrowings were RMB2.6b, $416.2m, compared with RMB2.5b at the end of 2012. Net inventory was RMB2.2b, $361.4m, compared with RMB 2.0b at the end of 2012.

With that, Operator, we are ready to begin the Q&A session. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Alex Potter, Piper Jaffray.

Alex Potter - *Piper Jaffray - Analyst*

Hi, guys. I was wondering if you could talk a little bit about the percentage of your production rate now that is compliant with NS IV?

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

Hi, Alex. It's Weng Ming here. Okay. Now as you know we have discussed the last -- on our conference call, whilst the National IV compliance engines has already been implemented regulation but the enforcement has not been strictly enforced across the board.

So other than those major cities, where the enforcement is strictly enforced, a large part of country is still not fully enforcing in a strict manner. So, the proportion of National IV engines that we're producing right now, although increasing but it's still not very big. The portion of -- proportion of National IV engines produced for the bus market is increasing. It's much larger than the truck market. That's answered your question?

Alex Potter - *Piper Jaffray - Analyst*

Okay. So, approximately how high do you think it is in the truck market? When you say it's not very big, does that mean it's 5% or 10% or more than that or less than that?

(multiple speakers)

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

It will be less than that. It will be less than that.

Alex Potter - *Piper Jaffray - Analyst*

Less than 5%?

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

Less than 10% definitely.

Alex Potter - *Piper Jaffray - Analyst*

Okay. Less than 10%. Okay. And then -- so if that's production, as it stands right now, where do you think that will go? If you look at your orders right now into November, December, or the first part of next year, do you see that proportion of NS IV increasing in your actual orders or is it still staying around 5%?

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

Well, we are seeing an increase in the bus market because the city is requiring, what I call, better environmental-friendly engine vehicles. In the truck market, we are not seeing it growing in a big way yet. So there are is still quite a fair bit of pre-buy in anticipation of the strict enforcement on National IV. We don't really know when that will come.

Alex Potter - *Piper Jaffray - Analyst*

Okay. So then this relates to my next question. If production and orders are not yet increasing for NS IV and the pre-buy is continuing, could it be still several quarters, where we get pre-buy continuing like this, driving big growth in truck and engine orders? Presumably, people wouldn't pre-buy, unless they thought there was strict NS IV enforcement coming. But if strict NS IV enforcement doesn't come, does that mean that we -- this pre-buy could just continue indefinitely?

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

Well, if it doesn't come at all, then there's -- you'll see it the way it is. So, it will come, I'm sure. The government really wants to control the environment in the country but how soon and how fast they're going to do it honestly, Alex, we don't have an idea right now, and I would hate to take a guess right now.

Alex Potter - *Piper Jaffray - Analyst*

Okay. So does it make you at all uneasy when you see these big growth numbers? And presumably, a big pickup in inventory of NS III trucks, when there's no real strict deadline for NS IV because, by definition, when somebody is pre-buying a truck, they're buying a truck that they don't really need now; they're buying a truck that they anticipate they will need over the next couple of quarters. So if everybody keeps pulling forward this demand, month after month after month, that seems like eventually we're going to hit a wall and volume is going to fall pretty substantially.

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

Yes. It would be difficult to forecast that. But I think we are very confident we believe that the government will come in and strictly enforce it but when -- honestly, it's difficult to tell. So, yes, the way we look at [thing] too as a function of -- is yes, it will come.

Alex Potter - *Piper Jaffray - Analyst*

Great. Okay. And then I was wondering if you could comment a bit on R&D. Over the last couple of years, I'd say that the R&D percentage of the -- as a percentage of sales has increased a bit. I'm just wondering if you think that's a trend that will continue going forward. Do you have targets for R&D as a percentage of sales? So that's question number one.

And then question number two is what are you spending the R&D dollars on mostly? Is it mostly the high horsepower stuff?

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

Yes. Well, to answer your question. One -- yes, it will not continuously increase by robotics. It will creep up basically because the cost of labor in China is a lot, it's going up in the double digit, and also we have now built a new R&D center in Nanning. We also will be seeing some additional cost there. Just, we need that center to attract talent to come to join us.

Now, the R&D spending so far is on getting our engines (inaudible) for a while right now to comply with National IV and V measures. However, we are working on the [possible] National VI engines [abroad]. So, and recently I think that the (inaudible) of focus on the gas engine, so we are working on that, and also working on ways to reduce our cost structure, our cost reduction. So that requires a fair bit of research and development. And we have estimates who is doing things and how we can improve the cost structure or cost base of this engine.

Alex Potter - *Piper Jaffray - Analyst*

Okay, okay. Very good. And then the last question I had was related to natural gas again. There have been some recent, I guess, concerns about gas availability and gas allocation potentially allocating more gas or the government potentially allocating more gas toward residential power generation and heating, as opposed to industrial and transportation markets. Have you seen that trend? And has that impacted sentiment or order volume for natural gas engine?

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

Well, the sentiment in natural gas is still very buoyant, certainly we're seeing this year a massive increase of competitors this year. The industry, as a whole is selling a lot more natural gas engines, in both trucks and buses I must say.

So we think that going into next year, that this trend will continue. So whether or not it will continue in the magnitude is questionable but we believe that it going to grow quite significantly next year.

Alex Potter - *Piper Jaffray - Analyst*

Okay. Thanks very much, guys.

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

Okay.

Operator

(Operator Instructions).

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

Okay, there's no question. I'd like to answer a question by [Mr. Keith Chen] on the cash flow statement. He'd like me to repeat on the cash flow statement.

I just want to assure that for the nine months, yes, we did generate positive cash flow. We have profit generating healthy EBITDA to cover our CapEx. Our estimated CapEx for the first nine months is close to RMB350m, the contract with our CapEx initiative that we are doing at the moment. Yes.

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

All right, there's a question here on -- it's about the 3Q sale number of natural gas engines, marine engines and heavy-duty engines.

As mentioned earlier, on the natural gas engine, we sold quite a number of them, in fact, it had very good sales. If you look at the numbers we sold about nearly 8,000 natural gas engines in the third quarter.

First, in the case of marine engines it's still quite small. We are look at this in a (inaudible) manner going forward but the heavy-duty engine sales improved as well compared to the previous year. We had quite a good growth in this heavy-duty engine.

Now, there's another question here asking when can visitors -- investors visit our R&D facility.

We are looking at that. Hopefully, we can organize something in the not-too-distant future, not just to visit our R&D facility but also perhaps to visit our engine plant as well. We do conduct some analyst visits from time to time. Yes.

There's a question here that asks about the JV status for Geely, Caterpillar and CIMC-Chery and the growth perspective in this joint venture.

And then I'll let Kevin answer this question. Thank you.

Kevin Theiss - *Grayling - IR*

Regarding on the status of our joint venture and [certainly] regarding on the Geely and then that we are still in the development stage, also the prototype engine of which is still under developing and then we are targeting an entity complete by the first half of 2014. So, following that and then the we'll still have the ongoing development.

Regarding on the CIMC-Chery, we have -- the production of [EC and NC] are pretty good and [about double] of last year. And then the production will be -- and going up in 2014 as well.

On the remain Caterpillar JV, the remanufacturing, we are now with the -- have business of (inaudible) on the remanufacturing business. We are now focusing on the remanufacturing engines but the whole business is still in the preliminary stage and then we expect and it will be growing the remanufacturing production by 2014 as well.

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

All right.

Operator

Thank you. We have now reached the end of the Q&A session, and I will turn the call back over to Mr. Hoh. Thank you, Mr. Hoh.

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

Thank you all for participating in the conference call for third quarter and nine months ended September 30. We look forward to speaking with you again. Bye.
