

Hong Leong Asia's diesel-engine unit expands capacity and bets on green technology

| BY JOAN NG |

From his spare, cramped office within the Hong Leong Building, Saw Boo Guan is trying to revive the fortunes of US-listed diesel-engine maker **China Yuchai International**. The problem isn't that Yuchai, which is controlled by **Hong Leong Asia** (HLA), is having trouble growing. On the contrary, China's strong economic growth has fuelled sales despite the recession. For 2Q2009, Yuchai reported revenues of RMB3.4 billion (\$703.5 million), a 17.9% increase q-o-q. The total number of diesel engines sold came to 129,932 units, up 6.7% in the same period.

Rather, it is that Yuchai has lurched from one corporate governance scandal to another since it was acquired by HLA in 2001 in a bid to diversify away from building materials and become a China play. In fact, Yuchai nearly lost control of its diesel-engine business during a tussle with the management of its operating company in China back in 2005. That prompted the company to acquire major stakes in two Singapore-listed companies as back-up businesses, namely, electronics distributor **Thakral Corp** and property company **HL Global Enterpris-**

its president.

Saw started work officially in August, and lost no time in engaging Yuchai's investors in the US. At the special general meeting convened earlier this month, Saw delivered a presentation that seemed to go down well. Besides confirming that Yuchai is indeed growing strongly, he also unveiled several initiatives based on green technology, a field that's becoming increasingly important in China as well as around the world. In fact, Yuchai has committed to spend 3% of its revenue from the engine business on research and development.

Already, Yuchai has developed a dual-fuel engine using a mix of natural gas and diesel, which results in increased diesel-fuel efficiency and lower emissions. The company has already supplied a set of initial units to Shanghai-listed **Zhengzhou Yutong Bus Co**, China's largest professional bus manufacturer. Yuchai has also developed an electric/diesel hybrid engine that is expected to reduce fuel consumption by 20%. The engine turns off when the vehicle is stationary, which means fuel is conserved while the vehicle is idling, but can restart instantly when the accelerator is depressed. A third engine



Saw has an impressive track record in building up markets for the kinds of engines Yuchai produces

— being with Cummins in Asia since 1989 — his extensive industry experience will undoubtedly take China Yuchai to levels unforeseen by shareholders," says Peter Delgado, a US-based shareholder. Prior to joining Yuchai, Saw was president of Cummins Westport, a producer of heavy-duty natural gas and propane alternative engines that meet the most stringent environmental standards in North America and Europe. Cummins Westport saw a 32% compound annual growth rate in revenue and a 65% growth in profit during the time Saw was president from 2005 to 2008, Yuchai said in a statement.

Besides Saw's industry experience, Yuchai itself is in good financial shape. Delgado points out that the company now has close to US\$8 per share in cash. "I am of the opinion that it is only a matter of time before a Wall Street firm picks up research coverage on Yuchai and when that occurs, the stock will easily trade to the mid-20s," Delgado says of Yuchai's stock, which closed on Sept 23 at US\$9.15.

Will Yuchai lift HLA?

If that happens, it won't just be shareholders in the US cheering. At current prices, HLA's holdings in Yuchai are

es (formerly LKN-Primefield).

Neither of those investments has paid off particularly well, though, and HLA has suffered ignominious setbacks in trying to set the direction at Thakral. And, while Yuchai has managed to regain control of its diesel-engine business in China, the company had to correct accounting errors going back to 2005, a task that it only managed to complete last year.

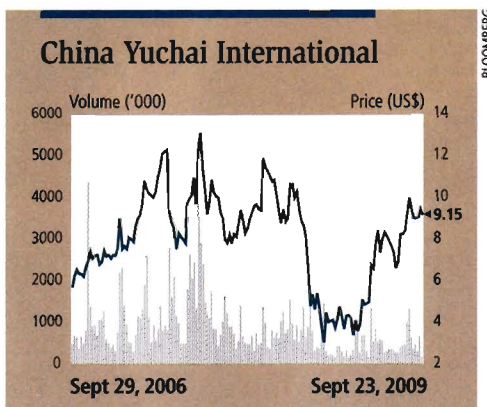
The result is that shares in Yuchai have performed disastrously, which has enraged its minority shareholders. Listed on the New York Stock Exchange in 1994 at US\$10 per share, the stock has spent most of the last four years trading below that price. Things seemed to come to a head in July when a group of investors demanded that a special general meeting be convened to consider several proposals. Among them were the removal of several directors and the removal of provisions relating to a special share that gives HLA significant control of Yuchai although the former holds just 21.2% of the latter.

That's when Saw stepped into the fray. A Malaysian who had spent most of his life working abroad, in the US, Canada, Mexico, Hong Kong, China and parts of Southeast Asia, Saw is married to a Singaporean and wanted a job here because his 18-year-old son was about to begin his national service in the Singapore Armed Forces. As Saw tells it, some friends of his recommended that he apply for a job in the Hong Leong group as the group is a reputable one. "I went through the interview process," he says simply. In June, Yuchai said it had appointed Saw

as CEO in the works is one that runs on dimethylether, a clean burning gas said to be 95% carbon-neutral.

While Saw's willingness to engage investors seems to have partially assuaged their anger, he still has to prove that he can deliver results. "The presentation was good, but the key will be the execution," says Himanshu Shah, president and chief investment officer of US-based Shah Capital Management, a boutique investment firm that was among the shareholders that pushed for the special meeting. "This is a step in the right direction... but there remains a lot to be accomplished." Among other things, Shah would like to see Yuchai expand and perhaps take over other diesel-engine businesses in China.

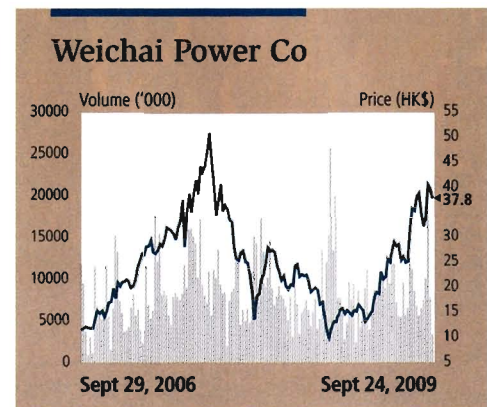
Nevertheless, Saw's performance at the special meeting appears to have bought him some time. None of the resolutions proposed by the dissident minority investors were passed at the meeting. And, Shah says he won't be making any other such moves for now. Can Saw now quickly turn Yuchai into a bigger company that grabs the attention of investors? What is his game plan? And, what are the obstacles in his path?



Expanded capacity, new markets

A veteran of the automotive industry with 23 years' experience within the Cummins organisation as well as at General Motors Corp (GM), Saw has an impressive track record in building up markets for the kinds of engines Yuchai produces. At the moment, Yuchai's engines are used mostly in trucks, buses and construction equipment. But, Saw is hoping to also put those engines into ships and power generators, which would significantly widen the company's customer base. Saw says Yuchai has already begun making sales to the marine industry, although the number of units sold is still very small. Meanwhile, development of engines for power generators, which involves attaching an alternator to the engine, is underway.

Yuchai is also expanding its operations. On Sept 9, the company announced the completion of phase one of a new diesel-engine-assembly factory in China's Fujian province. The factory has 120,000 sq m of space and is located within the Xiamen Automobile Industry City in Guannan Industrial Park. Annual production capac-



ity is expected to reach 100,000 units, which would be more than one-fifth Yuchai's 2008 production capacity of about 443,750 units.

On top of this, the company is also spending close to RMB1 billion on a new foundry that will be able to churn out about a million engine components — things like crankshafts and camshafts — a year. Saw says construction of the factory should be completed by year-end. That should put the company on a strong growth track. According to Saw, orders for Yuchai's engines have continued to rise and the company has even managed to grow its market share this year. Meanwhile, much of China's massive government stimulus package has been promised for the building of highways, airports and high-speed railways. All this, Saw says, is likely to lead to increased demand for Yuchai's engines.

There are risks ahead for Yuchai, though. For one thing, it has expanded its capacity during what could be a prolonged period of economic uncertainty, which could pressure its margins. In 2Q2009, Yuchai reported a 37.6% q-o-q decline in underlying earnings to RMB1.33 (19 US cents) per share, despite a strong rise in revenue, reflecting heightened price competition at the moment. Saw himself doesn't dismiss these risks. "A lot boils down to the economic condition," he says.

Investors familiar with Yuchai seem to think that Saw has the right credentials to steer Yuchai through the uncertainty, though. "Looking at his background

is worth about US\$72.3 million (\$102.3 million), versus its own market capitalisation of \$812.6 million. Any expansion in Yuchai's market value would probably lift HLA's too.

HLA treats Yuchai as a subsidiary company, consolidating its revenue and earnings in its accounts. However, while Yuchai accounts for the bulk of HLA's group revenue, it accounts for a much smaller portion of its earnings because of the large minority-interest element. DMG analyst Leng Seng Choon estimates that Yuchai will probably account for only 13% of HLA's FY2009 profits. The largest contributor to HLA's bottom line will likely be Henan Xinfei Electric Co, a 90%-owned Chinese white-goods maker. HLA's other significant earnings driver is its original building materials group. This year, HLA added to this business by acquiring a 72.6% stake in Malaysia-listed **Tasek Corp**, a cement company.

Yuchai is perhaps most closely comparable to **Weichai Power Co**, a company that produces diesel engines for heavy-duty trucks and construction machinery. Weichai also sells heavy-duty trucks and heavy-duty gear boxes. Over the past four years, as Yuchai struggled with its internal governance and accounting issues, it has underperformed Weichai dramatically. While Weichai generates 2½ times as much revenue as Yuchai, and more than five times as much in earnings, its market value is 16 times that of Yuchai. If Saw manages to keep the company on its growth track and ensures that its progress is accurately reflected in its accounts and communicated to investors, shares in Yuchai might just begin to recover some lost ground.