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CAAS - Q2 2019 China Automotive Systems Inc Earnings Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

William R. Gregozeski *Greenridge Global LLC - Founder*

PRESENTATION

Operator

Greetings, welcome to China Automotive Systems Second Quarter 2019 Conference Call (Operator Instructions) I will now turn the conference over to your host, Kevin Theiss. Thank you, you may begin.

Kevin Theiss - *China Automotive Systems, Inc. - Manager of IR*

Thank you, everyone, for joining us today. Welcome to China Automotive Systems' 2019 second quarter conference call. Joining us today are Mr. Qizhou Wu, Chief Executive Officer; and Mr. Jie Li, Chief Financial Officer of China Automotive Systems. They will be available to answer questions later in the conference call with the assistance of translation.

Before we begin, I will remind all listeners that throughout this call, we may make statements that may contain forward-looking statements. Forward-looking statements represent the company's estimates and assumptions only as of the date of this call. As a result, the company's actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those described under the heading Risk Factors in the company's Form 10-K annual report for the year ended December 31, 2018, as filed with the Securities and Exchange Commission on March 28, 2019, and in other documents filed by the company from time to time with the Securities and Exchange Commission. The company expressly disclaims any duty to provide updates to any forward-looking statements made in this call, whether as a result of new information, future events or otherwise.

On this call, I will provide a brief overview and summary of financial results for the 2019 second quarter. Management will then conduct a question-and-answer session. The following 2019 second quarter and 6 months financial results are un-audited and are reported under U.S. GAAP. For the purposes of our call today, I'll review the financial numbers in U.S. dollars.

We will begin with a review of recent dynamics of the automobile industry and China Automotive's market position. China's GDP growth in the second quarter of 2019 grew at 6.2%, down from 6.4% in the first quarter of 2019, and lower than the 6.7% for the second quarter of 2018.

Rate of growth represented the slowest growth in the last 27 years. China experienced a sharp decline in exports to the United States from 8.1% for the first 6 months of 2019.

The Chinese economy is becoming more dependent on domestic consumption but consumers are nervous and less willing to make major purchases. And the government is campaigning against pollution. New automotive emission standards, the National 6 were implemented on July 1 in some provinces and Tier I cities to improve air quality. And this resulted in restricted vehicle sales. This implementation in these areas is actually ahead of the scheduled national implementation of the new emission standard.

Unit sales of passenger cars and commercial vehicles declined by 9.6% in June and 12.4% in the first 6 months of 2019. The Purchasing Managers Index, PMI gauge the Chinese factory conditions, came in at 49.4 for June below the 50 level indicating economic growth has not reached an expansion stage, according to the National Bureau of Statistics.



For the month of June China's factory output growth slowed again to 51.3 from 51.7 in May, while total new orders declined to 49.6 from 49.8. Export orders continues to decline, falling to 46.3 from May's 46.5. Manufacturers continue to cut jobs in June with the employment declining to 46.9 compared with 47 in May.

According to data reported by the China Association of Automobile Manufacturers, CAAM, [believe that] vehicle production in June reflected a 17.3% year-over-year decline, with sales down 9.6% year-over-year.

For the first 6 months of 2019 production declined 13.7% year-over-year compared to the same period in 2018 and sales declined by 12.4% year-over-year. In June 2019, passenger car production declined 17.2% and sales were 7.8% down compared to June of 2018.

Commercial vehicle production in June was down 17.5% and sales down 17.8% year-over-year.

In the commercial vehicles segment, the traditional internal combustion bus market continued to experience a significant year-over-year decrease in unit sales in the second quarter of 2019. But overall truck sales were down 14.1% and total commercial vehicle sales declined by 13.9%. And lastly in this environment, net sales of our traditional hydraulic steering products declined by 15.9% year-over-year to \$83.1 million in the second quarter of 2019. This reduction reflects lower vehicle sales and market conditions in the second quarter of 2019 as well as the transfer of our EPS business to the Henglong KYB joint venture.

Our electric power steering product sales in the second quarter of 2019 was \$22.6 million, a 16.3% decline compared with the 2018 second quarter. As a percentage of net revenues, EPS sales accounted for 21.4% in the second quarter of 2019, which was consistent with the same quarter in 2018. We believe our Henglong KYB joint venture with Japan KYB Company Limited has the potential for stronger growth among Chinese and Japanese branded vehicles in the future. Our combined operations will increase our market position in the Chinese market for EPS products as well as create products to enhance exports in the future. We remain optimistic for the success of our exclusive contract with Great Wall Motor Company for our EPS systems to steer its new all-electric small vehicle model ORA R150. Approximately 100,000 units are expected to be shipped in 2019 under this contract.

We are also optimistic about the future of our joint venture with Hyoseong Electric Company to produce small electric motors for use in EPS systems. By producing these electric motors ourselves, we have better control over the quality, production and cost of these products for our own EPS systems. Recognize our growing steering technology, one of our Tier 1 customers in North America selected us to develop a new recirculating ball steering system, the i-RCB program for their autonomous vehicle project. Commercial production is expected in October 2019 with initial annual sales approximating 45,000 units.

Our export sales in North America of our hydraulic steering products decreased by 3.9% year-over-year in the second quarter of 2019. We're making progress on the i-RCB program to develop new re-circulating ball steering systems for that company's autonomous vehicle. The knowledge developed for these products will be used in other products in the future.

Second quarter 2019 gross margin increased to 14.4% from 13.5% in the second quarter of 2018, mainly due to changes in the product mix. We reduced our operating expenses by 14.2% in the second quarter of 2019. And income from operations in the second quarter of 2019 increased [69.2%] to \$2.7 million in the second quarter of 2019 compared with \$0.6 million in the second quarter of 2018.

Net income attributable to parent company's common shareholders increased to \$2.5 million or diluted earnings per share of \$0.08 compared to net income attributable to parent company's common shareholders of \$0.8 million per diluted earnings per share \$0.03 in the second quarter of 2018. As of June 30, 2019, cash and equivalents and pledged cash were \$89.1 million.

At the Annual General Meeting on July 18, 2019, Dr. Henry Lu and Dr. Tong Kooi Teo were elected as new independent members of the Board of Directors. They replaced Mr. Arthur Wong and Mr. Robert Tung who did not stand for reelection.



For 2019 and beyond, the central government has initiated a fiscal stimulus plan included about CNY 2 trillion or \$291 billion of tax cuts, which is slowly affecting the economy. Other recent government actions include, using the regulations for using government debt in some infrastructure projects to help boost the economy.

China's National Development and Reform Commission has announced new monetary incentives to promote growth in the automobile sector. Rural area consumers can trade in vehicles with older emissions standards to purchase more efficient compact vehicles. The plan will subsidize replacement of cars complying with the 2007 emission standards, and cars with engines of 1.6 liters or smaller in rural areas. And some state-owned companies are also adding incentives to encourage the purchase of automobiles to stimulate new car purchases, including significant discounts to sell new vehicles that do not meet the new emission standards. Vehicle sales under these programs may affect future sales later in 2019.

As one of the largest suppliers of high-quality steering products in China, we are well positioned to benefit from new growth opportunities, even as we continue to supply a number of Tier 1 joint venture -- I'm sorry -- Tier 1 vehicle manufacturers in North and South America. We've ventured into joint ventures to establish better market position in the EPS market, create a foothold in autonomous steering and gain knowledge in other emerging steering technology. We continue to be financially strong and maintain the resources to accomplish our strategic goals.

Now, let me review the financial results for the second quarter of 2019. Our net sales decreased 15.9% to \$105.7 million compared to \$125.8 million in the same quarter of 2018. Net sales of traditional steering products declined by 15.9%, the demand weakened in the Chinese domestic brand automobile market. Additionally, the company sales to its North American customers declined by \$1.1 million. Sales of electric power steering represented 21.4% of total net sales.

Gross profit decreased to \$15.2 million in the second quarter of 2019 compared to \$17 million in the second quarter of 2018. The gross margin was 14.4% in the second quarter of 2019 versus 13.5% in the second quarter of 2018. The gross profit decrease was mainly due to lower sales, higher unit costs and a change in product mix.

Gain on other sales was \$2.5 million in the second quarter of 2019 compared to \$1 million in the second quarter of 2018. Selling expenses were \$3.9 million in the second quarter of 2019 compared to \$4.9 million in the second quarter of 2018. The decrease was mainly due to lower logistics expenses related to decreased sales during the quarter. Selling expenses represented 3.7% of net sales in the second quarter of 2019 compared with 3.9% in the second quarter of 2018.

General and administrative expenses, G&A were \$4.4 million in the second quarter of each of 2019 and 2018. G&A expenses represented 4.2% of net sales in the second quarter of 2019 compared to 3.5% in the second quarter of 2018. The percentage increase was mainly due to reduced sales in the second quarter of 2019.

Research and development expenses, R&D expenses decreased 18.5% to \$6.6 million in the second quarter of 2019 compared to \$8.1 million in the second quarter of 2018. R&D expenses continue to focus on the development of the company's EPS and other new products. R&D expenses represented 6.2% of sales in the second quarter of 2019, comparing with 6.4% in the second quarter of 2018.

Income from operations was \$2.7 million in the second quarter of 2019 compared to \$0.6 million in the same quarter of 2018. The increase was primarily due to a higher gain on other sales and lower operating costs. As a percentage of net sales, the operating margin was 2.6% in the second quarter of 2019 compared to 0.5% in the second quarter of 2018.

Net financial income in the second quarter of 2019 was \$1.6 million, compared with \$0.9 million in the second quarter of 2018. Income before income tax expenses and equity in earnings of affiliated companies increased 143.5% to \$3.1 million in the second quarter of 2019 compared to \$1.3 million in the second quarter of 2018.

Net income attributable to parent company's common shareholders increased 196.3% to \$2.5 million in the second quarter of 2019 compared to net income attributable to parent company's common shareholders of \$0.8 million in the corresponding quarter of 2018.

Diluted earnings per share were \$0.08 in the second quarter of 2019 compared to diluted earnings per share of \$0.03 in the second quarter of 2018. The weighted average number of diluted common shares outstanding was 31,499,577 in the second quarter of 2018 compared to 31,647,305 in the second quarter of 2018.

Now, we will go over 6 months financial highlights. Net sales decreased 17.3% to \$214.9 million in the first 6 months of 2019 compared to \$259.8 million in the first 6 months of 2018. Six months gross profit was \$29.2 million compared to \$38.7 million in the corresponding period last year.

Six month gross margin was 13.6% in the first 6 months of 2019 compared to 14.9% in the corresponding period in 2018. Gain on other sales was \$3.8 million in the first 6 months of 2019, compared with \$2.5 million in the corresponding 6 month period last year.

Income from operations was \$3.8 million in the first 6 months of 2019 compared to \$5.2 million in the first 6 months of 2018. Operating margin was 1.8% in the first 6 months of 2019 compared to 2% in the corresponding period of 2018. Net income attributable to parent company's common shareholders was \$4 million in the first 6 months of 2019 compared to \$5.2 million in the corresponding period in 2018. Diluted earnings per share were \$0.13 in the first 6 months of 2019 compared to diluted earnings per share of \$0.16 in the corresponding period of 2018.

We will now go over some balance sheet and cash flow items. As of June 30, 2019 cash and equivalents and pledged cash was \$89.1 million. Total accounts receivable including notes receivable were \$255.1 million. Accounts payable was \$184.1 million. Short-term loans were \$71 million. Total parent company's stockholders' equity was \$308.5 million as of June 30, 2019, compared to \$304.8 million as of December 31, 2018.

Net cash used in operating activities was \$25.7 million in the first 6 months of '19 and compared with net cash used in operating activities of \$5.4 million in the first 6 months of 2018. Payments to acquire plants -- property, plant and equipment were \$10.3 million, compared with \$17.3 million in the first 6 months of 2018.

The business outlook, management has revised its revenue guidance for the full year 2019 to \$430 million from \$510 million. This target is based on the company's current views on operating and market conditions, which are subject to change.

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

QUESTIONS AND ANSWERS

Operator

[Operator Instruction] Our first question is from William Gregozeski with Greenridge Global.

William R. Gregozeski - *Greenridge Global LLC - Founder*

Sales to the North American customers fell in the quarter. What are you expecting for the remainder of 2019 and into 2020 from these customers?

Unidentified Company Representative

[Interpreted] The first -- in the first half of 2019, our export to North America was around USD 55 million. And we anticipate the second half sales to the North America customer will have a slight increase due to a new model of product coming out, i-RCB product that's coming out for the second half of 2019. So that will increase the total sales in the second half. 2020, we see the total sales in North America will be equivalent to 2019. So it's going to be similar or flat.



William R. Gregozeski - *Greenridge Global LLC - Founder*

So we should not expect really any growth going forward on this market?

Unidentified Company Representative

[Interpreted] Yes, the short answer is, yes. In terms of North America sales in 2020, well we would not expect a increase, it will be flat compared with 2019. We see, in terms of international sales, we see the growth will be coming from other markets such as South America. We have a contract with Chrysler -- sorry, with Fiat, that's a 300,000 units shipment for 2020. Also we have -- also with the Fiat in Europe, that's another 125,000 in 2020. So these are the growth area we see internationally.

Domestically, in China, we see our joint venture with KYB will boost our sales. That joint venture would take off in a significant way. So we have a number of product upgrade and -- so we think the EPS product in 2020 is going to be a much stronger in terms of growth.

William R. Gregozeski - *Greenridge Global LLC - Founder*

Can you talk a little more about the KYB? How is the customer reaction been to that and when will we see that business turn profitable?

Unidentified Company Representative

[Interpreted] So in terms of customer feedback, after 6 -- more than 6 months fine-tuning in our KYB joint venture our quality, our product quality has increased significantly. We -- just to give you some examples, we use some of the higher-grade materials, we also did some finetuning on the engineering. And so now, in terms of quality, we have reached Japanese standards, the same level of product quality standard KYB is selling in the Japanese market. So with that we already received overwhelming positive feedbacks from our domestic Chinese customers.

On the cost side, also we make measures right during this period. We have made some of the cost reductions on the production side, fine-tuned the production procedures. And now our gross margin increased from previous 13% where we are producing to now 18%. So that's a significant improvement in terms of cost structure. Because of volumes right now in 2019 still hasn't reached the level we invested. And so we are seeing 2019 KYB joint venture is going to be a slight loss. However, we expect that will turn around in 2020 to turn profit. So that will be a boost in 2020's business.

William R. Gregozeski - *Greenridge Global LLC - Founder*

And the last question is with the sales -- overall sales falling, why are we still seeing the inventory increase?

Unidentified Company Representative

[Say the question again.]

William R. Gregozeski - *Greenridge Global LLC - Founder*

The sales are falling, and obviously the guidance is for lower sales in the near future, but the inventory is still increasing from previous levels, why is that?



Unidentified Company Representative

[Interpreted] To answer your question, it's mainly due to -- the inventory increase is mainly due to the product mix shift, and product -- our sales structure or our product mix has changed during the quarter. However, we don't see this inventory increase as significant. We increased from \$88 million end of the year to \$90 million now, in terms of inventory. These are mainly shifting from some of the components we used to use for hydraulic product now we're moving to other kinds of products. So and we believe this is a natural change because we are in response to the market, we are shifting our sales mix to adapt to the market trend. So I will not worry about it, the inventory at the moment.

William R. Gregozeski - *Greenridge Global LLC - Founder*

With the lower guidance, I mean is there any risk then that some of the products you might have on hand you might need to do like a larger write off later this year?

Unidentified Company Representative

[Interpreted] Okay. We do have appraisal evaluation of our inventory every quarter. And whatever we need to do to make a provision it's already been done. And there's no more provision needed in terms of inventory at this moment. So to answer your question, we don't see any further writedown coming.

Operator

Our next question is from [Robert Paulovic], private investor.

Unidentified Participant

I have a couple of questions. The first is the Hyoseong joint venture for the electric motors. I was wondering where you are in regards to production? I know they were building a plant I think for this product. I guess what stage are we in with that? And will these motors ultimately be sold to I guess other companies making electric power steering systems? It's just a thought but I'm thinking that might be the case.

Unidentified Company Representative

[Interpreted] Okay. So the Hyoseong joint venture, in terms of status, right now their workshop it has been completed. Construction of the workshop or the production factory has been completed. Now we're doing the interiors at this moment. We believe it will be done by the end of October. And at the meantime, the equipment we ordered will be coming in from Korea during that time. And we will start trial production probably at the end of October. And we'll have a prototype coming out during that time as well in the [first] quarter, and our plan is to launch mass production in March 2020. So that's the general plan in terms of Hyoseong joint-venture.

Unidentified Company Representative

[Interpreted] Okay. To your question on future sales on electric motors from this joint venture into other companies EPS producers, yes, the show answer is yes. Our design capacity for this joint venture is 3 million units annual production. With the Phase 1 we are aiming at 1 million units. In Phase 1 that 1 million units will be mainly used internally for [CAS] product and EPS product. The remaining or the additional 2 million coming online, we'll decide, a lot -- a big portion of that will be used for sales to other EPS producers.



Unidentified Participant

My next question is regarding, I guess, the U.S. market, North America and Brazil. I know Brazil you have some operations, either assembling, I don't know what the extent is products at that location. In light of everything going on with the U.S. and trade issues, what would they -- what would a good strategy be at this point to make sure that you continue to develop and grow in the North American market?

Unidentified Company Representative

[Interpreted] Malaysia. Okay. So we -- yes, in terms of trade issues, ongoing trade issues, we have extended conversation with our customers in [North America]. The -- in terms of specifically on how we're going to tackle the incremental part of it. So we have made some positive progress in terms of our negotiation, our discussion with our customers, how we going to share the increase of tariff. We remain optimistic. We have some resolution coming.

And in terms of your comment on South America, in particular, Brazil market. We have increased our capacity in Brazil. As we mentioned earlier, in 2020 we have already in an order book from Fiat, South America, 300,000 units. That's for 2020. And so we are increasing South America, in particular, the Brazil facility's production. And we're hoping that will also help us to become another route to the U.S. market as and -- but most of the product will be produced locally and in Brazil.

Other -- in terms of other locations, we're looking at Canada and possibly Malaysia as well. These countries are not in a crosshair of the trade dispute. So we are working on some of the markets to develop another solution. So that being said, we think we'll -- we are making progress, we are making strategic planning to diversify as well as to maintain our growth prospects in North America and other international markets.

Unidentified Participant

I had another question. And it has to do with. Back in the fall, I guess there was a go-private proposal and that was pulled for China Automotive to become a privately owned company. Just wondering where are we -- or where is China Automotive at this point in their position? Are they committed to remaining a public company at this point? And if so the company did have a share buyback in effect. Is that something that will still be ongoing? And those are my final questions.

Unidentified Company Representative

[Interpreted] There is no further plan or intention to go private as far as we heard from large shareholders. And we are committed to be a U.S. listed Chinese -- a U.S. listed company.

In terms of the share buyback; we, as you may you have heard in the past quarters and even a year also China -- Chinese government has implemented very strong capital control restrictions for capital to leave China. And it's the whole process has become longer in terms of application. But we have coming -- to a point, we believe our process application for capital to come out to do share buyback has reached a point. And we should see that our fund will get approved in the near future.

And so with that, we will resume our share buyback as we announced in the past. So yes, so that's part of the plan.

Operator

(Operator Instructions) That concludes today's teleconference. You may disconnect your lines at this time. And thank you for your participation.



Kevin Theiss - *China Automotive Systems, Inc. - Manager of IR*

Thanks for participating in today's conference call. We look forward to speaking with you again.

Unidentified Company Representative

Thank you. Bye-bye.

Operator

Thank you.

[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]

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