

SECTOR UPDATE

Industrial Automation – China

Component Names May Outperform Heading Into Results Period

Most leading automation names in China have resumed positive growth from a low base in May-Jun 23 after a brief correction in April. Component players are generally performing better than the market's previous expectations, while robots may disappoint due to EV clients asking for shipment delays. Heading into the results period, we now prefer Inovance for its resilient earnings growth, while Estun may take a back seat as the market monitors its shipment delivery. Maintain OVERWEIGHT.

WHAT'S NEW

- **After a hiccup in April, automation demand is recovering, albeit at a slower pace.** China's industrial automation sector was under pressure through May, as demand growth in April turned out worse than expected (negative yoy growth) amid price cuts and sluggish demand, while the subsequent recovery was relatively slow, as indicated by the sluggish official manufacturing PMI numbers in May-Jun 23. However, domestic names continued to outperform compared to that of foreign competitors, as domestic names face lower ASP and destocking thanks to better inventory management. New orders grew 10-20% yoy on average but were flattish mom in June, with Inovance outperforming its peers at 30-40% yoy growth. Nevertheless, note that the yoy growth is likely due to a low base effect, as China was still impacted by COVID-19 lockdowns in Jun 22.
- **By industry, solar, robots and end-user markets still outperforming the rest.** Air conditioning applications and semiconductors registered positive growth, while pneumatic equipment, lathes and textiles remained sluggish. Capex for EVs and Li-ion batteries continued to slow.
- **Japan machine tool export orders on the downtrend.** Japan's machine tools orders remained sluggish in June, according to Japan Machine Tools Builders Association, with export numbers down 16.7% yoy and 2.0% mom to ¥80b, and the declines likely driven by both the US, China and Europe.
- **Backed by China, Yaskawa (6506 JP/Not rated) reported strong orders growth in June quarter.** Important takeaways from our call include: a) Yaskawa's June quarter operating profit was below expectations, as there were shipment delays for industrial robots of EV clients; b) orders growth (entirely driven by China) was above market expectations at ¥137b (consensus: ¥134b), with Yaskawa's servo motor orders surging 36% yoy in China during the quarter, driven by energy storage (ESS) and solar and solar; and c) management remains positive on China for both servo motors (solar and ESS) and robots (EVs).

The implications of Yaskawa's results include: a) a negative read on the industrial robot makers (such as Estun), as the shipment delays should be an industry-wide issue for the June quarter; b) the strong growth in servo motors is likely due to a very low base (Japanese automation players was most severely impacted by COVID-19 lockdowns in 2Q22), but nevertheless sheds a positive light on the upstream component players.

OVERWEIGHT (Maintained)

SECTOR PICKS

Company	Ticker	Rec	Share Price (Rmb)	Target Price (Rmb)
Inovance	300124 CH	BUY	68.08	82.00

Source: UOB Kay Hian

PEER COMPARISON

Company	Ticker	Rec	Price @ 12 July 23 (Rmb)	Target Price (Rmb)	Upside/ (Downside) to TP (%)	Market Cap (Rmbm)	PE 2023F (x)	PE 2024F (x)	P/B 2023F (x)	P/B 2024F (x)	ROE (%)	Net Gearing (Cash) (%)
Inovance	300124 CH	BUY	68.08	82.00	20.4	180,140	36.7	31.1	7.4	6.2	19.1	(23.3)
Estun	002747 CH	BUY	25.00	31.50	26.0	21,665	68.9	52.6	6.7	6.1	8.8	82.3
Shuanghuan Driveline	002472 CH	HOLD	32.22	33.00	2.4	27,400	26.3	20.1	2.5	2.3	10.1	4.7
Han's Laser	002008 CH	HOLD	25.77	29.00	12.5	27,103	18.9	14.8	2.0	1.8	8.6	(32.0)

Source: Bloomberg, UOB Kay Hian

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- **Inovance is expanding into linear guide equipment through the acquisition of Korea SBC.** In end-Jun 23, Inovance announced that the company has completed the acquisition of SBC, a Korean linear motion solutions provider. SBC's products include ball guides, roller guides, robot carrier guides and ball screws for linear motion equipment. Linear guide components are primarily used in precision machinery such as computer numerical control (CNC) lathes (which is one of Inovance's development focus), and has a market size of ~US\$22-23b globally (US\$5-6b in China). The market primarily consists of Japanese (NSK, THK), European (INA), and Taiwanese (Hiwin, PMI) players, with very few participants from the domestic names especially in the high-end market, hence it is an area with large import substitution potential.
- **SHD announced its first overseas product plant in Hungary.** Shuanghuan Driveline (SHD) announced in early-Jul 23 that it will invest around €120m in Hungary to build a manufacturing base for the production of EV gears (gearbox and components). This will be a long-term project, and while contribution may begin from 2025, SHD is targeting to achieve a more meaningful production scale by 2026 so that the planning, construction and ramp-up will span >3 years. Also, phase one of the production line will likely only cover the later parts of the production process such as assembly, testing and fine-tuning. While the absolute contribution remains small in the near term, we understand that SHD's European clients had been requesting SHD to build a production line with closer proximity to their Europe supply chain before placing more orders, such that the establishment of an overseas production base will be crucial in further order wins in the overseas market for SHD.
- **Export orders for Japan Machine tools remain on the downtrend.** Japan Machine tools orders reported by Japan Machine Tools Builders Association remained sluggish in June, with export numbers down 16.7% yoy and 2.0% mom to JPY80b, with the declines likely driven by both the US, China and Europe. Nevertheless, while the detailed breakdown of June's data is not yet released, we believe the yoy decline in new orders growth from China has bottomed in May, and its growth should start to pick up as the government launch more stimulus towards property and infrastructure spending.

ACTION

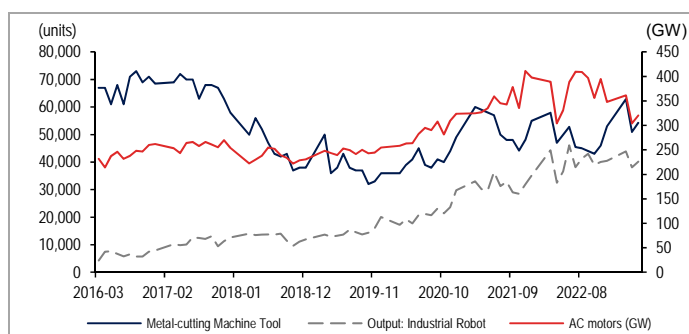
- **Maintain OVERWEIGHT.** While the recovery remains slow, the strong data point in May-June's channel check shows that the industry condition is not as tough as expected. We believe the industry is steadily recovering going forward and we still expect robots to outperform components in terms of growth this year. However, market's focus has now shifted to 2Q23 results, of which the component players may outperform robot names due to delays in deliveries during the quarter. As such, our pick order for the coming 1-2 months is Inovance > Estun.
- **Inovance (300124 CH/BUY/Target: Rmb82.00).** We believe Inovance will outperform its peers leading up to the 2Q23 results, as the company should be one of the best performers with a +10-20% yoy earnings growth (vs flattish in 1Q23). Coupling with stabilising orders growth in May-June, solid 2Q23 results should address investor concerns on slowing growth amid the global industrial automation downcycle. Currently, Inovance is our top pick, and our target price of Rmb82.00 is based on 45.5x 2023 PE, 0.5SD above historical forward mean.
- **Estun (002747 CH/BUY/Target: Rmb31.50).** While Estun remains our top pick for 2H23 among the China industrial automation sector, we see short term pressure to its share price as its 2Q23 results may disappoint given the delayed shipment in EV and Li-ion battery sectors. Nevertheless, we believe the orders are not cancelled and merely delayed and pushed back to later quarters, such that we keep our estimates and target price of Rmb31.50 unchanged.
- **Shuanghuan Driveline (002472 CH/HOLD/Target: Rmb33.00).** Under our coverage, SHD was the best performer in June, as investors are excited about its potential entry into Tesla Bot's supply chain. However, while we like SHD for its resilient growth and technological edge, we believe the contribution from humanoid robots will remain minimal in the coming three years, as: a) humanoid robots are still too expensive to be

economically viable, and b) the technology is still at an extremely preliminary stage on both the hardware and software front, with the development roadmap still in its infancy and the final designs still subject to change.

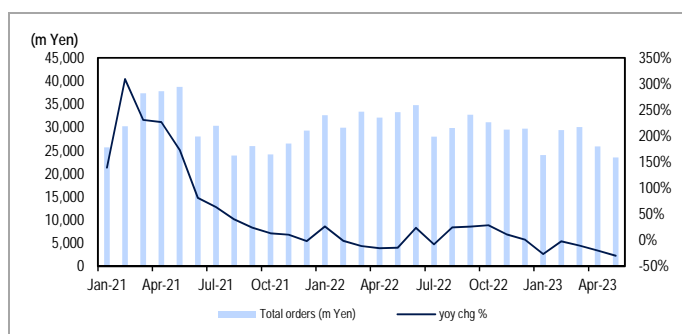
As such, we now recommend capitalising on the robust rally and await a better entry point as its current price is already fairly valued at 35x 2023F PE (1x PEG, on a par with historical average). We change our rating from BUY to HOLD for now and our target price remains unchanged at Rmb33.00.

- **Han's Laser (002008 CH/HOLD/Target: Rmb29.00).** Given the sluggish recovery in China's economy and spending in consumer electronics, we trim our sales assumption on Han's Laser's revenue for PCB and low power laser equipment. Our net profit ends up 3% lower, and we adjust our target price down to Rmb29.00 accordingly. Maintain HOLD.

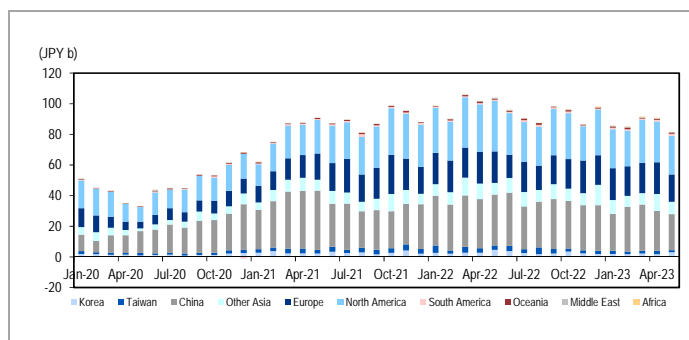
SALES VOLUME BASED ON MACHINE TYPES



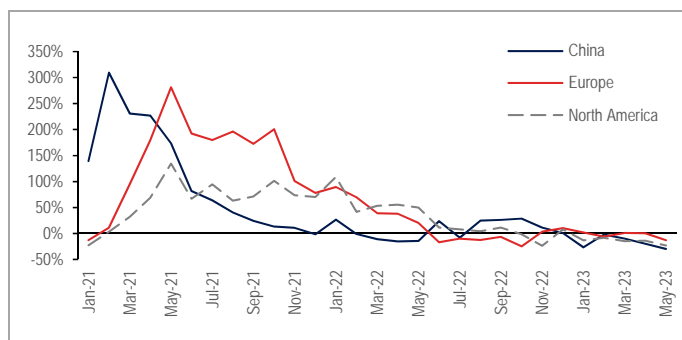
JAPANESE MACHINE TOOLS ORDER FROM CHINA



JAPANESE MACHINE TOOLS SALES VOLUME GEOGRAPHICAL BREAKDOWN



JAPANESE MACHINE TOOLS YOY GROWTH BASED ON REGION



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