



J.P. Morgan's
Hands-On China Series

Views you can use

HANDS-ON CHINA REPORT
February 8, 2011

Jing Ulrich

Managing Director, Chairman,
China Equities & Commodities
+852 2800 8635
jing.l.ulrich@jpmorgan.com

Amir Hoosain

+852 2800 8641
amir.h.hoosain@jpmorgan.com

Benjamin Wong, CFA

+852 2800 8932
benjamin.mc.wong@jpmorgan.com

Kelvin Wong

+852 2800 8962
kelvin.x.wong@jpmorgan.com

Postcard from the World's Fastest Train, the CRH380

The expansion of China's high-speed railway (HSR) network played a key role in boosting construction and generating employment during the external economic slowdown, while meeting the national objective of improving connectivity to the hinterland and freeing up traditional railways to carry more freight. On our recent trip along the Shanghai-Hangzhou HSR route during the Chinese New Year period, the amount of progress made in just the last couple years was astonishing.

We took the high-speed train between Shanghai and Hangzhou – a service that began operating last October (after a construction period of just 20 months) and has shortened the travel time between the two cities from 1.5 hours to 45 minutes. Investment in the 202-km line is said to have totaled RMB29.3 billion.

It is the sudden proliferation of many such HSR routes and the associated demand for trains that has made China South Locomotive & Rolling Stock Corporation Limited (CSR; 1766.HK) the world's third largest high-speed train producer behind Bombardier and Alstom.



On December 3, the company's 16-car CRH380A set a world record by reaching a speed of 486.1 km/h during a trial run. During our short journey from Shanghai to Hangzhou, the train reached a peak speed of 348km/h. The CRH380A is one of four Chinese trains designed to run at a top speed of 380 km/h in commercial service, the other three being:

- CRH380B, developed by China North Locomotive and Rolling Stock (CNR; 601299.CH) in cooperation with Siemens.
- CRH380C, which is based on the CRH380B and incorporates a redesigned nose and electrical equipment from Hitachi.

- CRH380D produced by a joint venture between Bombardier and CSR Sifang Rolling Stock (a subsidiary of CSR).

If considered in combination, CSR and CNR (which were separated into two companies in 2000) would constitute the world's largest rail company by operating revenue. CSR recently announced that it expects its 2010 net profit to rise by more than 50% from RMB1.68 billion in 2009.

While on board, we were advised by a proud engineer that this relatively short route was currently being used to test run the CRH380B train intended for the Beijing-Shanghai HSR route – a \$33 billion, 1318km line that will halve the travel time between the two cities to less than five hours upon its scheduled launch this summer. Business class seats on the trains are comparable to first class seats used in commercial aviation, and we were told each seat is produced at a cost RMB170,000. Of the sixteen compartments on the train, every other car contains a locomotive.



Shanghai's Hongqiao Station – a hub for high-speed rail

A focal point for China's railway ambitions is Hongqiao Railway Station, a RMB 15 billion facility that opened last summer adjacent to Terminal 2 of Shanghai's Hongqiao International Airport. The Hongqiao Railway Station was constructed to serve high speed trains between Shanghai and Hangzhou, Nanjing, Suzhou, Wuxi, Fuzhou, Wenzhou, Nanchang, Xiamen, Beijing and several other cities in China. It is effectively the largest transport transfer hub in the country, integrating rail, air, subway, local and long-distance bus services. While extremely busy during the Chinese New Year holiday, the facilities could only be described as impeccable.

Above the HSR platforms and bus transfer center situated on the first floor of the station, the second floor is a 10,000 square meter area featuring numerous shops, restaurants, bars and other amenities for waiting passengers. Train tickets can be purchased from 154 ticket windows and 80 vending machines. Hongqiao railway station is now the largest railway station in Asia, but around China, similarly grand facilities such as Beijing South Railway Station and Guangzhou North Station have recently opened to service the HSR network.

HSR – undoubtedly convenient, but not without detractors

A first-class ticket on the Shanghai-Hangzhou line costs RMB131 (US\$19.89) while a second-class ticket costs RMB 82 (US\$12.45). This compares very favorably to the Acela Express service from Washington DC to Philadelphia (a distance of 136 miles, compared to 120 miles between Shanghai and Hangzhou), where first class tickets cost US\$236, while business class seats cost \$144.

Even so, the prices for first and second-class seats on the Shanghai-Hangzhou route have increased 108% and 56%, respectively, when compared to the ordinary train service. At the same time, it has been reported that the number of ordinary trains in service has been sharply reduced from several dozen to only ten, meaning that cheaper tickets have become difficult to obtain.

Indeed the issue of affordability has been presented as a source of social controversy in recent media reports. Although the Shanghai-Hangzhou line constitutes a linkage between two relatively affluent cities in China, a less favorable picture of HSR has been painted in accounts of the annual journey of several hundred million workers to their hometowns for the Chinese Lunar New Year holiday. The Xinhua News Agency recently published an article about a migrant family who, after queuing for five hours, were unable to purchase ordinary train tickets at the usual price of RMB76 and could only obtain second class HSR tickets from Hangzhou to Jiangxi province at an extra cost of RMB400 for the family of three. At an incremental cost amounting to one-third of the father's monthly salary, the reduction in travel time by several hours provided little relief.

According to an article in the *Oriental Morning Post*, cheaper tickets on the HSR route between Shanghai and Chengdu have sold out during the holiday migration, but hundreds of soft berths on the trains (with tickets costing up to RMB2,330) remained vacant. In the absence of cheap train tickets, many passengers have opted to take long-distance buses this year, putting extra pressure on the road transport system during the Chinese New Year period. The Ministry of Transport has estimated that a record 2.6 billion bus trips will be made between January 19 and February 27, an increase of 11.6% over last year's holiday period. This will be aided by a 9% increase in the operating bus fleet during the period.

In other reports, experts have raised concerns that the sudden build-out of a national HSR infrastructure could trigger an increase in local budget deficits and will mean that the need for component replacement and upgrades could become a major issue in future (since railway assets would decline and depreciate around the country in synchrony).

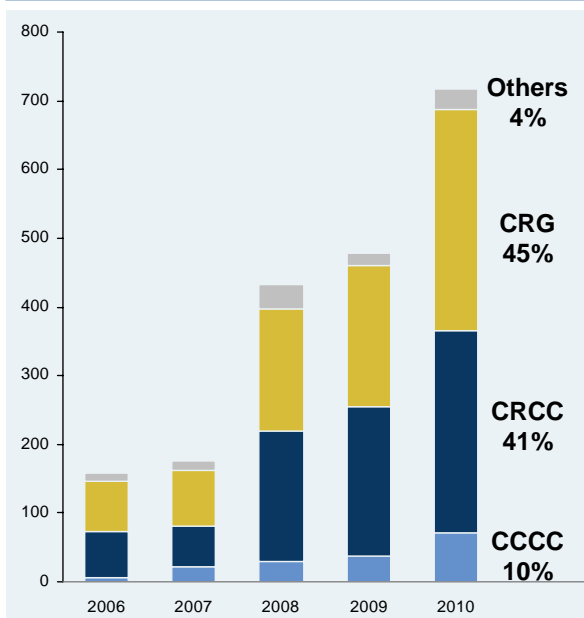
World's most ambitious capex plans

Although such reports paint an unclear picture about the financial prospects of railway operators, the resolute commitment to expand the HSR network by the nation's leaders should bolster China's railway contractors and train manufacturers. The 12th Five-year plan period will be a historic peak for railway construction in China, with RMB 3-4 trillion in railway capex expected over the coming five years (in terms of civil works only), and 120,000km of railway track targeted by 2015 vs. 91,000km at end-2010. By the end of the plan period, 16,000km of HSR track (13.3% of the national railway network) is expected to be in operation.

J.P. Morgan infrastructure analyst Karen Li believes the RMB700 billion railway capex guidance for 2011 appears conservative given a 49% rise in railway new orders in 2010. Her top picks in the sector are CSR, and China Railway Group (CRG; 390.HK). CRG experienced solid new order momentum over 2010 and saw its market share increase 2ppt to 45% (see *Figure 1*), mostly at the expense of China Railway Construction Corp, the country's number two railway builder (which recently disposed of an unprofitable contract for building a light railway in Mecca to its parent company). Meanwhile, China Communications Construction (CCCC) saw its market share rise from 8% in 2009 to 10% in 2010.

As more railway track is completed in the coming years, Karen Li expects the amount of spending on equipment and rolling stock should grow to account for >30% of railway spending, from 10% at present. CSR's price target was recently raised to HK\$13.3, implying 24.1% upside from current levels to reflect the company's improving margins; the company also stands to benefit from further increases in government spending and business growth in overseas markets (the company signed an agreement with GE in December to establish a 50-50 joint venture to manufacture high speed trains in the US, using Chinese technology).

Figure 1a: Breakdown of railway orders won by contractors (RMB bn)



Source: MOR, J.P. Morgan Research by Karen Li *based on consensus estimates

Figure 1b: Earnings growth + PE ratio

	JPM Rec.	EPS growth (2011e)	PE ratio (2011e)
CCCC 1800.HK	N	13%	8.5
CRCC 1186.HK	OW	83%	9.9
CRG 390.HK	OW	18%	9.8
CSR 1766.HK	OW	42%	27.1
CNR* 601299.CH	NR	56%	22.8

Disclaimer

J.P. Morgan is a marketing name for investment banking businesses of JPMorgan Chase & Co. and its subsidiaries worldwide. JPMorgan Chase & Co. or any of its affiliates (collectively, "J.P. Morgan") makes no representation or warranty regarding the accuracy or completeness of the information herein. J.P. Morgan is not an advisor to any person in respect of any referenced transaction.

This material is not the product of J.P. Morgan's research departments and along with any associated verbal presentation (together the "Presentation") is purely indicative and is based on current assumptions and market conditions. Although information contained herein has been obtained from sources which we believe to be reliable, none of J.P. Morgan, nor any person acting on their behalf, makes any representation or warranty, implied or express regarding the accuracy or completeness of the information contained herein. The Presentation is not intended as an offer or solicitation for the purchase or sale of any financial instrument, nor does it constitute a commitment by J.P. Morgan to enter into any transaction referred to in the Presentation. J.P. Morgan shall incur no responsibility or liability whatsoever to the client or to any other person in respect of the Presentation and in the event that J.P. Morgan enters into any transaction described in the Presentation then such transaction shall be governed exclusively by the relevant transaction documents.

The recipient must make an independent assessment of any legal, credit, tax, regulatory and accounting issues and determine with its own professional advisors any suitability or appropriateness implications of any transaction referenced herein in the context of its particular circumstances. J.P. Morgan assumes no responsibility or liability whatsoever to any person in respect of such matters. This material is directed exclusively at market professionals and institutional investors and is not for distribution in any jurisdiction where such distribution contravenes applicable laws of any relevant jurisdiction, nor could it be distributed to any other person or replicated in any form without the prior written consent of J.P. Morgan. Notwithstanding any prior written consent provided by J.P. Morgan for the further distribution or replication of these materials and as consideration therefore, the initial recipient of these materials acknowledges to J.P. Morgan that it shall hold J.P. Morgan harmless for the consequences of such further distribution or replication (as the case may be).

Copyright 2010 JPMorgan Chase & Co. All rights reserved. Additional information is available upon request.