Corporate Flash

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Shandong Molong: Emerging OCTG producer in China

Recommendation: BUY (initiating coverage) — China Energy Logistics

Price	HK$4.10
Target price	HK$5.14 (+25.4%)
12 mth range	HK$1.70-4.20
Market cap.	US$340.6m
Daily t/o, 3 mth	US$0.2m
Free float %	27.4%
Ticker	0568.HK/568 HK

Year to Dec	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
05A	85.2	0.141	15.1	28.8	6.41	111.2	0.9	26.0	23.0	Cash
06A	139.4	0.215	52.7	18.9	4.97	68.8	0.9	29.7	23.1	Cash
07F	209.8	0.323	50.4	12.5	3.71	48.9	1.8	33.9	26.8	Cash
08F	237.0	0.366	13.1	11.1	2.93	42.9	2.0	29.5	25.9	Cash
09F	272.9	0.421	15.2	9.6	2.36	38.0	2.3	27.2	24.6	Cash

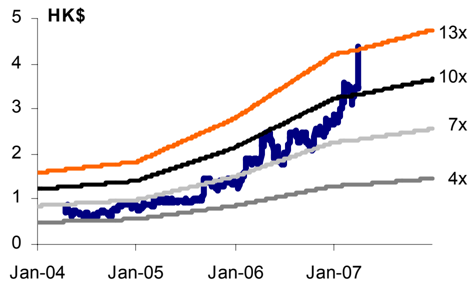
Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +21.9%, +50.1%, +78.8%
Actual price changes (1 mth, 3 mth, 12 mth): +24.2%, +46.4%, +124.0%
Note: On Pro Forma basis

Key points:

- Certified supplier of PetroChina and Sinopec.
- Set to benefit from the expansion in China's oil exploration.
- Offers broad product range.
- Capacity expansion.
- Strong three-year net profit CAGR of 25.1% between FY12/06A and FY12/09F.
- Strong sales growth to offset margin contraction.
- Deserves a premium given its high earnings visibility.

Corporate profile. Based in China's Shandong province, Shandong Molong Petroleum Machinery is engaged in the design, manufacture and sales of petroleum drilling and extraction machinery and related accessories. It offers pipes, sucker rods, pumps and pumping machines for oil wells as well as casings and other petroleum drilling and extraction machinery accessories.

Chart 1: P/E bands

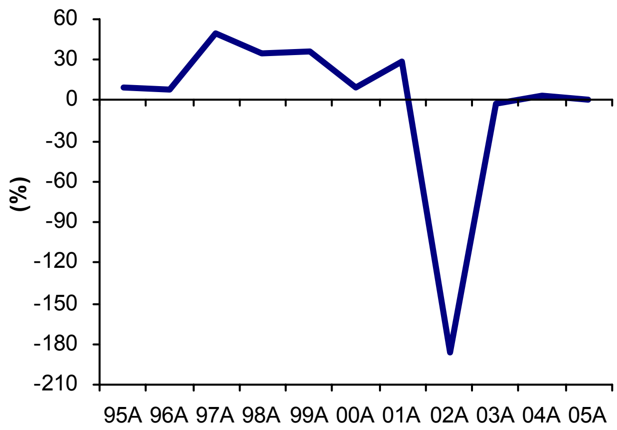


Source: SBI E2-Capital

Favorable operating environment. The revenue of oil country tubular goods (OCTG) producers and other petroleum machinery manufacturers depends on exploration and production (E&P) activities of the global oil and gas industry. Strong crude oil prices have boosted up E&P around the world. According to Baker Hughes World Rig Count, the total number of rigs increased from 560 at the beginning of 2000 to 981 in February 2007, representing a growth rate of 75.2%. However, should the crude oil prices head south, which we think is unlikely, E&P activities will decrease eroding the revenue of OCTG and other petroleum machinery makers.

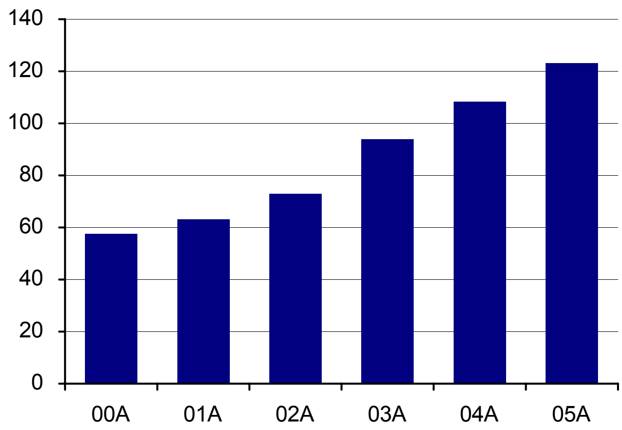
China's booming oil E&P. Unlike their global peers, China OCTG and petroleum machinery producers are relatively immune to crude oil price fluctuations. Accounting for more than 20.0% of China's total energy consumption, crude oil is a vital energy source for the country's rapidly expanding economy. With China's growing industrialization and affluence, crude oil consumption rose at a 10-year CAGR of 7.5% between 1995 and 2005 to about 7.0m barrels per day. As a result, crude oil reserves were depleted at a 10-year CAGR of 0.2%. According to BP Statistical Review of World Energy, China's overall crude oil reserve replacement ratio (RRR) declined to 0.0% in 2005 from 8.9% in 1995. To boost crude oil reserves, China's oil producers stepped up their E&P with Sinopec's (386 HK, HK$6.63, NR) capex up at a five-year CAGR of 9.7% between FY12/00A and FY12/05A. Between 2001 and 2006, PetroChina's (857 HK, HK$9.22, NR) and CNOOC's (883 HK, HK$6.84, NR) capex on E&P increased at a five-year CAGR of 18.2% and 31.8%, respectively. PetroChina's capex on E&P for FY12/07F is budgeted at RMB115.2b, representing an annual growth rate of 9.5%.

Chart 1: China oil reserve replacement ratio



Source: BP Statistical Review of World Energy

Chart 2: China E&P Capex



Source: PetroChina, Sinopec, CNOOC

Certified quality. The company has been awarded the "Quality Management System Certificate" (ISO9001:2000) by the China Classification Society Quality Assurance Ltd., an independent ISO quality assurance organization, for the design, development and manufacture of petroleum machinery for oil extraction. The certificate will expire in January 2009. The American Petroleum Institute (API) also licensed the company to use its API Monogram on certain products, including pumps and pump parts, sucker rods and couplings, casing and oil well pipe products.

On giants' vendor lists. Suppliers of subsidiaries or branch oil fields of PetroChina (857 HK, HK$8.72, NR) or Sinopec (386 HK, HK$5.96, NR) must be members of the Beijing Information Services Branch of PetroChina Sales Company and Sinopec's Material and Equipment Department. Shandong Molong joined the two in 2001. An API Monogram license and ISO9001 are necessary to become a member of these institutions.

Direct sales to domestic clients. In FY12/06A, China contributed 61.0% of the company's sales, with the remainder coming from overseas markets. The company's major domestic customers are PetroChina's oilfields, including Xinjiang, Daqing, Changqing, Liaohe, Qinghai, and Huabei, and Sinopec's Shengli, Zhongyuan and Jianghan. It is worth to note that because the company sells its products directly to its domestic customers, it can quickly respond to clients' requests and provide effective customer service. It has five domestic sales offices covering Xinjiang, Northeast China, Northwest China, North China and Middle China, with a sales and marketing team of 60.

Firm market position. PetroChina and Sinopec are the group's major domestic customers. The group's sales to PetroChina accounted for 0.4% of PetroChina's E&P capex in FY12/03A, 0.5% in FY12/04A and 0.5% in FY12/05A. Its sales to Sinopec accounted for 0.1%, 0.3% and 0.5 % of Sinopec's E&P capex, in the same years respectively. Oil field engineering firms are not price sensitive, but quality sensitive, in our view. Drilling and production machinery accounts for only a small proportion of their exploration capex and since faulty machinery can jeopardize an exploration project, oil producers select their suppliers based mainly on quality considerations. Market positions of China's state-owned oil producers' certificated vendors are firm, as the entry barrier is high due to stringent product quality requirements. As state-owned oil producers put quality above price, certificated vendors should be able pass cost increments to their customers.

Overseas expansion. The proportion of overseas sales increased to 39.0% in FY12/06A from 15.3% in FY12/03A. Petroleum Pipe Company (PPC) is Shandong Molong's major overseas customer, accounting for 2.1% of its turnover in 4M FY12/06A. ITE Inc and others accounted for 0.4% and 34.8% of the total turnover, respectively. Established in 1975, PPC is a leading distributor of casing, tubing and line pipes, with offices in Dubai, Houston the US, China, Azerbaijan, Kazakhstan, Australia, Columbia, Canada, Russia, India and Singapore. Through PPC, the company's products can reach virtually all corners of the world. China-made petroleum machinery products are cost and price competitive compared with overseas products, but there are not as high grade and the global high-grade oil well pipe segment is still dominated by Japanese manufacturers. We expect Chinese makers to upgrade their technology and gradually enter the high-end market. The company has set up an export department to develop the overseas market.

Sales to expand at the expense of the blended margin. The company's production capacity is expected to increase 15.0% to 92,000 t.p.a for oil well pipes and 28.6% to 4.5m meters for sucker rods in FY12/07F from 80,000 tons and 3.5m meters in 8M FY12/06A. The gross profit margin of oil well pipes and sucker rods is expected to widen to 28.0% and 30.0%, respectively, from 24.5% and 26.8% in 4M FY12/06A, due to an increase in sales of high-grade products and better economies of scale. As the group's new casings production facilities came on stream in 4Q FY12/06A, its casing production capacity is expected to reach 150,000 t.p.a. in FY12/07F and 200,000 t.p.a. in FY12/08F, from 90,000 t.p.a. in 8M FY12/06A. The gross profit margin of casings is 18.0pcp lower than that of oil well pipes. As the sales contribution of casings increases, the group's blended margin will be eroded. We expect casings' contribution to represent 39.8% of the total revenue in FY12/07F and 44.8% in FY12/08F, and its blended margin to narrow to 17.7% in FY12/07F and 16.9% in FY12/08F. However, a surge in turnover will more than offset this negative impact on the bottom line.

Table 1: Production capacity projections

Year to Dec	05A	8M06A	07F	08F	09F
Oil well pipes					
Production capacity ('000 tons)	60.0	80.0	92.0	92.0	92.0
Volume ('000 tons)	54.0	53.4	83.7	85.6	87.4
Oil well sucker rods					
Production capacity ('000 tons)	3,500.0	3,500.0	4,500.0	4,500.0	4,500.0
Volume ('000 tons)	3,390.0	2,191.0	4,050.0	4,140.0	4,185.0
Oil well pumps					
Production capacity (# of units)	10,000.0	10,000.0	10,000.0	10,000.0	10,000.0
Volume (# of units)	7,797.0	6,806.0	8,000.0	8,900.0	9,000.0
Casings					
Production capacity ('000 tons)	10.0	90.0	150.0	200.0	250.0
Volume ('000 tons)	3.8	24.2	105.0	140.0	175.0
Oil well pumping machines					
Production capacity (no. of sets)	200.0	200.0	200	200	200
Volume (no. of sets)	198.0	141.0	190	186	188

Source: Company data, SBI E2-Capital

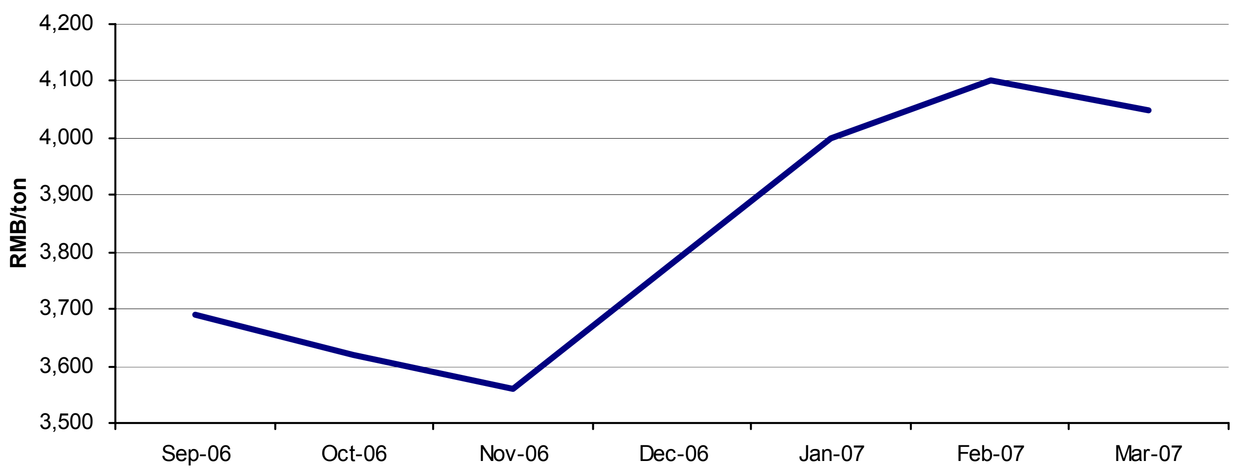
Table 2: Gross profit margin by product

Year to Dec	05A	8M06A	07F	08F	09F
Oil well pipes (%)	23.9	24.5	28.0	28.0	28.0
Oil well sucker rods (%)	28.3	26.8	30.0	30.0	30.0
Oil well pumps (%)	39.7	53.9	53.9	53.9	53.9
Casings (%)	14.9	10.3	12.0	12.0	12.0
Oil well pumping machines (%)	7.6	9.9	9.9	8.0	10.9
Other machinery accessories (%)	18.5	18.8	26.0	26.0	26.0
Blended margin (%)	23.2	23.2	17.7	16.9	16.3

Source: Company data, SBI E2-Capital

Increase in steel price. Raw material costs account for more than 92.0% of the group's COGS and steel billets are the group's major raw material. The steel plate price in Shanghai increased 7.1% since December 2006 to RMB4,050.0 per ton in March 2007. Increasing raw material costs will put pressure on the group's gross profit margin.

Chart 3: Steel plate price in Shanghai



Source: Bloomberg

Track record. Driven by the 30.6% YoY increase in turnover to RMB1,014.0m and a 11.8 pcp drop in the effective tax rate, the group's net profit surged 63.6% YoY to RMB139.4m, or RMB0.215 per share in FY12/06A. Meanwhile, its gross profit margin remained at 23.2% during the period under review. As of the end of December 2006, the group had RMB48.4m in net cash. Driven by strong growth of oil well pipe sales, the group saw its turnover and net profit increase at a three-year CAGR of 49.7% and 46.9%, respectively, between FY12/03A and FY12/06A. Meanwhile its gross profit margin narrowed from 24.9% in FY12/03A to 23.2% in FY12/06A, due to changes in its product mix.

Earnings forecast. We expect casings sales to boost turnover and net profit at a three-year CAGR of 37.2% and 25.1% between FY12/06F and FY12/09F. FY12/07F earnings should rise 50.5% YoY, mainly due to higher sales, and with growth at only 12.9% YoY in FY12/08F on conservative capacity, utilization rate and blended margin assumptions and the high base in FY12/07F. Since the group's subsidiary, Molong Drilling Equipment, was designated by the Ministry of Civil Affairs of Shandong Province as a welfare enterprise, it is entitled to full exemption from corporate income tax between FY12/05A and FY12/06A. We expect the group's effective tax rate to remain low at 11.8%, given Chinas' introduction of the uniform tax rate effective from 2H 2007 and VAT tax exemption on the purchase of domestically made machinery.

1 for 4 splits. The group proposed a final cash dividend of RMB0.02 per share, bring its whole-year cash dividend to RMB0.035, representing a payout ratio of 16.3%. In addition, it proposed to distribute a scrip dividend to shareholders on the basis of two new shares for each existing share, which will result in the issue of 1,296.0m new shares. Besides, the group plans to give bonus shares on the basis of two new shares for each existing share, with 1,296m shares issued upon the allotment. The exercises will boost its total issued share capital to 3,240m shares by the end of FY12/07F and dilute EPS for FY12/07F by 80.0%.

Valuation. On the pro forma basis, the group is trading at P/E of 12.5x for FY12/07F and 11.1x for FY12/08F, against the peer group's average P/E of 12.1x for FY12/07F and 9.0x for FY12/08F. In our opinion, China's OCTG and petroleum machinery producers deserve a premium against global peers, given their high earnings visibility and immunity to crude oil price fluctuations. The group should trade on a premium to its close HK-listed counterpart, Anhui Tianda Oil Pipe (8241 HK, HK$5.13, HOLD), given its better earnings quality. Anhui Tianda sells its products to traders and offers two product categories, unlike Shandong Molong, which deals with oil producers in China directly and offers more than 10 product categories. Based on the 30.0% premium on the sector average P/E for FY12/07F, we set our pro forma-based target price at HK$5.14. With a potential upside of 25.4%, we initiate coverage on Shandong Molong with a BUY recommendation.

Table 3: Peer group comparison

Company name	Ticker	Year end	Currency	Market cap (US$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward	EV/EBITDA 1-yr forward	EV/EBITDA 2-yr forward
Lone Star Technologies	LSS US	Dec	USD	2,025	17.3	11.6	5.5	4.4
Grant Prideco	GRP US	Dec	USD	6,377	12.6	10.9	8.0	7.0
Hydril	HYDL US	Dec	USD	2,049	19.8	16.1	10.9	9.4
Vallourec	VK FP	Dec	EUR	13,704	10.1	9.6	4.8	4.5
Tenaris SA	TEN IM	Dec	EUR	27,069	11.9	7.5	7.3	7.4
Anhui Tianda Oil Pipe	8241 HK	Dec	HKD	336	11.7	9.7	7.9	6.8
Enric Energy Equipment	3899 HK	Dec	HKD	240	19.5	14.1	14.7	10.6
Average					*12.1*	*9.0*	*6.8*	*6.5*

Source: Bloomberg, SBI E2-Capital

Products categories. The company is able to provide most of the components of a typical oil well structure. It offers:

- Oil well pipes - essential for the oil well structure, connected they form a column tube, which extends from the company through the oil well down to the oil layer and allows oil to flow from underground to the surface. The group produces regular, tip thickened and special seamless varieties. In January 2001, the American Petroleum Institute (API) granted the group the right to use the API Monogram for API Specification 5CT on its oil well pipes products.
- Oil well sucker rods - placed inside an oil well pipe and attached between an oil well pump and an oil well pumping machine, which pushes and pulls the oil well sucker rod up and down creating forces in the oil well pump to draw oil from the well. The company produces two kinds of oil well sucker rods, regular and super-strength. In May 2001, the API granted it the right to use the API Monogram for API 11B Specification on its oil well sucker rods.
- Oil well pumps - placed inside oil wells, oil well pumps are used in the process of oil extraction to lift oil

from underground to the surface. The oil well sucker rod forces the pump up and down, creating a suction that draws oil up through the oil well. The company manufacturers three kinds of oil well pumps, regular, special and underground petro-electric. The API granted it the right to use the API Monogram for API 11AX Specification on its sub-surface sucker rod pumps and fittings.

- Casings - used for the assembly of cylinders which extend from the ground surface to the oil level and serve as oil well walls. The company produces two types of casings, ordinary and seamless. In January 2001, it obtained the right from the API to use the API Monogram for API Specification 5CT on its casing products.
- Oil well pumping machines - generate power for oil extraction.
- Other petroleum drilling and extraction machinery accessories - mud pump steel sleeves, regular valves, large-size high pressure spherical valves, blade-guide pulleys and fluid injection pumps.

History. The predecessor of Shandong Molong, the Petroleum Machinery Parts Factory, was established in March 1987 as a collectively-owned enterprise engaged in the manufacturing and sale of petroleum machinery parts. In 1989, the factory was re-registered as the Petroleum Machinery Factory, which changed its name to Weifang Molong in 1993. In 1994, Weifang Molong was transformed into Molong Holdings. In December 2001, Molong Holdings was incorporated as a joint stock company with limited liability and listed on the GEM Board of HKEX on April 2004. On July 2004, with approval of China's Ministry of Commerce, it was transformed into a Sino-foreign equity joint venture. On May 2005, it raised HK$94.8m through a placement of 108.0m shares at HK$0.92 each. On February 2007, it was listed by the way of introduction of its entire issued H-share capital on the main board of HKEX.

P & L (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	**776.5**	**1,014.0**	**1,899.8**	**2,248.1**	**2,618.0**
% chg	*59.2*	*30.6*	*87.3*	*18.3*	*16.4*
Gross profit	180.4	235.5	336.6	379.8	425.8
EBITDA	118.2	190.9	268.8	306.4	345.9
Depre./amort.	(13.4)	(26.6)	(27.8)	(36.4)	(36.5)
EBIT	104.8	164.3	241.1	270.0	309.4
Net int. income/(exp.)	(1.4)	(8.2)	(13.7)	(13.9)	(13.8)
Exceptionals	12.1	5.7	16.1	18.9	21.2
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**115.5**	**161.8**	**243.5**	**275.0**	**316.8**
Tax	(27.3)	(19.1)	(28.7)	(32.4)	(37.4)
Minority interests	(3.0)	(3.3)	(4.9)	(5.6)	(6.4)
Net profit	**85.2**	**139.4**	**209.8**	**237.0**	**272.9**
% chg	*38.9*	*63.6*	*50.5*	*12.9*	*15.2*
Dividends	(24.0)	(22.7)	(46.6)	(52.6)	(60.6)
Retained earnings	61.2	116.7	163.2	184.3	212.3
EPS (HK$) - Basic	0.141	0.215	0.097	0.073	0.084
EPS (HK$) - F.D.	0.141	0.215	0.065	0.073	0.084
DPS (HK$)	0.037	0.035	0.014	0.016	0.019
No. sh.s o/s (m) - W.A.	604.8	648.0	2,160.0	3,240.0	3,240.0
No. sh.s o/s (m) - Y.E.	648.0	648.0	3,240.0	3,240.0	3,240.0
No. sh.s o/s (m) - F.D.	648.0	648.0	3,240.0	3,240.0	3,240.0
Margins (%)					
Gross	*23.2*	*23.2*	*17.7*	*16.9*	*16.3*
EBITDA	*15.2*	*18.8*	*14.2*	*13.6*	*13.2*
EBIT	*13.5*	*16.2*	*12.7*	*12.0*	*11.8*
Pre-tax	*14.9*	*16.0*	*12.8*	*12.2*	*12.1*
Net	*11.0*	*13.7*	*11.0*	*10.5*	*10.4*

Balance Sheet (RMBm)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	354.4	532.5	655.5	767.7	746.9
Intangible assets	0.3	0.3	0.3	0.3	0.3
Other LT assets	5.3	9.0	9.0	9.0	9.0
Cash	257.8	253.4	328.2	426.8	704.2
Accounts receivable	75.7	169.9	230.1	272.3	317.1
Other receivables	29.8	41.6	66.9	79.2	92.2
Inventories	213.9	447.6	633.6	757.9	888.8
Due from related co.s	22.0	-	-	-	-
Other current assets	-	-	-	-	-
Total assets	**959.1**	**1,454.2**	**1,923.5**	**2,313.0**	**2,758.4**
Accounts payable	(421.2)	(611.7)	(967.6)	(1,145.0)	(1,333.3)
Other payable	(38.9)	(59.0)	(91.7)	(108.5)	(126.4)
Tax payable	(23.4)	(18.7)	(37.4)	(58.5)	(82.8)
Due to related co.s	(10.6)	(23.0)	-	-	-
ST debts	(50.0)	(135.0)	(54.8)	(65.6)	(77.1)
Other current liab.	-	-	-	-	-
LT debts	-	(70.0)	(50.0)	(20.0)	-
Other LT liabilities	-	-	-	-	-
Total liabilities	**(544.1)**	**(917.5)**	**(1,201.5)**	**(1,397.6)**	**(1,619.6)**
Share capital	64.8	64.8	324.0	324.0	324.0
Reserves	345.4	463.8	384.8	572.7	789.7
Shareholders' funds	**410.2**	**528.6**	**708.8**	**896.7**	**1,113.7**
Minority interest	4.9	8.2	13.1	18.7	25.1
Total	**415.1**	**536.8**	**721.9**	**915.3**	**1,138.8**
Capital employed	465.1	741.8	826.8	1,000.9	1,215.9
Net (debt)/cash	207.8	48.4	223.3	341.2	627.1

Cash Flow (RMBm)	05A	06E	07F	08F	09F
Year to Dec					
EBIT	104.8	164.3	241.1	270.0	309.4
Depre./amort.	13.4	26.6	27.8	36.4	36.5
Net int. paid	5.5	16.0	14.5	15.5	18.2
Tax paid	(9.5)	(6.7)	(10.1)	(11.4)	(13.1)
Dividends received	-	-	-	-	-
Gross cashflow	**114.2**	**200.2**	**273.2**	**310.6**	**351.0**
Chgs. in working cap.	185.1	(94.6)	94.0	15.5	17.4
Operating cashflow	**299.4**	**105.6**	**367.3**	**326.1**	**368.4**
Capex	(55.9)	(223.2)	(123.2)	(149.0)	(149.0)
Free cashflow	**428.6**	**(212.2)**	**338.1**	**192.6**	**236.9**
Dividends paid	(21.1)	(20.7)	(31.6)	(49.0)	(55.8)
Net distribution to MI	-	-	-	-	-
Investments	(41.7)	(71.6)	-	-	-
Disposals	0.8	-	-	-	-
New shares	100.5	-	-	-	-
Others	(132.2)	50.6	(37.6)	(10.2)	122.2
Net cashflow	**149.8**	**(159.4)**	**174.9**	**117.8**	**285.8**
Net (debt)/cash - Beg.	58.0	207.8	48.4	223.3	341.2
Net (debt)/cash - End.	207.8	48.4	223.3	341.2	627.0

Interim Results (RMBm)	05A	06A
Six months to Jun		
Turnover	**323.9**	**443.4**
% chg		*36.9*
Profit from operations	51.2	80.7
Interest expenses	(1.7)	(3.8)
Associates	-	-
Jointly-controlled entit.	-	-
Pre-tax profit	**49.5**	**76.9**
Tax	(11.7)	(25.4)
Minority interests	(1.3)	(1.1)
Net profit	**36.6**	**50.4**
% chg		
EPS (RMB) - Basic	0.064	0.078
DPS (RMB)	0.020	0.015

Shareholding Structure	Shares o/s (m)	%
Zhang En Rong	279.5	43.1
Other domestic shareholders	122.2	18.9
Mackenzie Inc.	69	10.6
Public	177.3	27.4
Total	**648.0**	**100.0**

Background

Based in Shangdong Province, Shangdong Molong Petroleum Machinery is engaged in the design, manufacture and sales of petroleum drilling and extraction machinery and related accessories. It offers oil well pipes, oil well sucker rods, oil well pumps, oil well pumping machines, casings and other petroleum drilling and extraction machinery accessories. The group was founded in 1998 and listed on the GEM board of HKEX on 2004. On February 2007, the group listed by the way of introduction of the entire issued H share capital on the main board of HKEX.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Net ROE (%)	26.0	29.7	33.9	29.5	27.2
EBIT ROCE (%)	28.3	27.2	30.7	29.6	27.9
Dividend payout (%)	28.2	16.3	22.2	22.2	22.2
Effective tax rate (%)	23.6	11.8	11.8	11.8	11.8
Net interest coverage (x)	75.1	20.0	17.6	19.4	22.3
A/R turnover (days)	38.9	44.2	38.4	40.8	41.1
A/P turnover (days)	138.7	185.9	151.7	171.5	172.8
Stock turnover (days)	108.4	155.1	126.2	135.9	137.1

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months
BUY : absolute upside of >10% over the next six months
HOLD : absolute return of -10% to +10% over the next six months
SELL : absolute downside of >10% over the next six months