

Shandong Molong: Miners' one-stop shop

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Recommendation: Not Rated

China Energy Logistics

Price	HK\$3.33	Yield (3/05A)	1.1%
12 mth range	HK\$1.70-3.80	ROE (3/05A)	26.0%
Market cap.	US\$272.5m	Net gearing (3/05A)	cash
No. shares o/s	648.0m	Net cash/sh. (3/05A)	HK\$0.324
Daily t/o, 3 mth	US\$0.19m	BV/sh. (3/05A)	HK\$0.639
Free float %	27.4%	Consensus EPS	
Major shareholder	Zhang En Rong – 43.1%	- 3/07F	na
Ticker	0568.HK/ 568 HK	- 3/08F	na

Key points:

- Set to benefit from the expanding global oil exploration activities.
- Broad product category.
- Supplies PetroChina and Sinopec.
- Overseas sales on the rise.
- Production capacity expanding.
- Turnover and earnings up at a two-year CAGR of 60.3% and 39.2%, respectively.
- Sector re-rating expected.

Corporate profile. Based in 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.

Certified product 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 its 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 the 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 Material and Equipment Department. Shandong Molong joined the two in 2001. An API Monogram licence and ISO9001 are necessary to become a member of these institutions.

Direct sales to domestic clients. In 9M FY12/06A, China contributed 67.5% of the company's sales, the US 13.4%, other countries 10.7% and Europe 8.4%. The company's major domestic customers are oil fields of PetroChina and Sinopec. In 4M FY12/06A, PetroChina accounted for 46.3% of the company's RMB190.9m domestic sales, Sinopec 9.4% and other domestic customers 7.0%. 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 in Xinjiang, Northeast China, Northwest China, North China and Middle China, with a sales and marketing team of 60.

Overseas expansion. The proportion of overseas sales increased to 32.5% in 9M FY12/06A from 15.3% in FY12/03A. Petroleum Pipe Company (PPC) is Shandong Molong's major overseas customer, accounting for 2.1%

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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. Revenue from pipe sales accounted for 64.4% of total turnover in FY12/05A. The gross profit margin of oil well pipes widened to 24.5% in 4M FY12/06A from 12.5% for FY12/03A but the blended margin narrowed to 23.9% in 4M FY12/06A from 24.9% in FY12/03A because of a lower sales contribution from drilling and extraction machinery accessories. The company's oil well pipe and sucker rod production capacity is expected to increase 15.0% in FY12/07F from 80,000 tons and 3.5m meters in 8M FY12/06A. Its production capacity of casings increased to 90,000 tons in 8M FY12/06A from 10,000 tons in FY12/05A and is expected to reach 150,000 tons in FY12/07F and 200,000 tons in FY12/08F. The gross profit margin of casings is 14.2pcps lower than that of oil well pipes. As the sales contribution of casings increases, the blended margin will be eroded but the gross margin of casings should improve on better economies of scale. Another major factor that affects the gross margin is raw material costs. Raw material and component costs represented 100.0% of the company's COGS.

Table 1: Gross profit margin by product

(%)	03A	04A	05A	4M05A	4M06A
Oil well pipes	12.5	15.3	23.9	18.9	24.5
Oil well sucker rods	37.1	24.4	28.3	24.9	26.8
Oil well pumps	33.4	36.4	39.7	23.2	53.9
Casings	14.0	13.8	14.9	9.0	10.3
Oil well pumping machines	27.9	18.0	7.6	11.7	9.9
Other petroleum drilling and extraction machinery accessories	35.0	25.6	18.5	23.3	18.8
Blended margin	24.9	19.8	23.2	19.2	23.9

Source: Company

Table 2: Production capacity

	03A	04A	05A	8M06A
Oil well pipes				
Production capacity ('000 tons)	30.0	55.0	60.0	80.0
Volume ('000 tons)	25.4	42.2	54.0	53.4
Oil well sucker rods				
Production capacity ('000 meters)	3,000.0	3,500.0	3,500.0	3,500.0
Volume ('000 meters)	2,600.0	2,500.0	3,390.0	2,191.0
Oil well pumps				
Production capacity (# of units)	10,000.0	10,000.0	10,000.0	10,000.0
Volume (# of units)	9,800.0	8,300.0	7,797.0	6,806.0
Casings				
Production capacity ('000 tons)	-	10.0	10.0	90.0
Volume ('000 tons)	-	2.9	3.8	24.2
Oil well pumping machines				
Production capacity (no. of sets)	200.0	200.0	200.0	200.0
Volume (no. of sets)	120.0	185.0	198.0	141.0
Regular oil well pipes				
Production capacity ('000 tons)	20.0	35.0	35.0	55.0
Volume ('000 tons)	20.0	33.0	35.0	34.4
Tip thickened oil well pipes				
Production capacity ('000 tons)	10.0	20.0	25.0	25.0
Volume ('000 tons)	5.4	9.2	19.0	19.0
Special seamless oil well pipes				
Production capacity ('000 tons)	-	60.0	60.0	60.0
Volume ('000 tons)	-	30.0	60.0	40.2

Source: Company

Proven track record. The group's turnover and net profit increased at a two-year CAGR (FY12/03A and FY12/05A) of 60.3% and 39.2%, respectively, to RMB776.5m and RMB85.2m. It reported a 49.3% YoY surge in net profit to RMB86.7m in 9m FY12/06A, exceeding the FY12/05A figure of RMB85.2m. As of the end of 1H FY12/06A, the company had RMB112.1m net cash in hand.

Opportunities. We believe establishing or acquiring a special steel-manufacturing base could enhance the gross profit margin. Besides, demand for high-grade oil well pipes is expected to increase, since mining companies will increase exploration in offshore and Western China. We expect Shandong Molong to develop high-grade oil well pipe and casing products.

Products. 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 manufactures 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.

Table 3: Revenue by product

(%)	03A	04A	05A	4M05A	4M06A
Oil well pipes	44.5	53.6	64.4	68.9	69.5
Oil well sucker rods	17.4	13.1	10.4	10.0	10.5
Oil well pumps	7.2	4.5	1.0	1.8	1.8
Casings	1.0	4.2	3.5	7.0	3.6
Oil well pumping machines	1.2	1.2	1.2	1.3	1.3
Other petroleum drilling and extraction machinery accessories	28.7	23.4	19.5	11.0	13.3
Total sales (RMB m)	302.3	487.7	776.5	228.4	304.2

Source: Company

History. The predecessor of Shandong Molong, the Petroleum Machinery Parts Factory was established in March 1987 as a collectively owned enterprise and 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 it 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 the entire issued H-share capital on the main board of HKEX.

Connected transaction. On September 2005, company entered into a Oil Well Pipe Billets and Casing Billets Supply Agreement with Weihai Baolong, which is a non wholly-owned subsidiary of Molong Machinery. The two companies are independent of Shandong Molong and considered its connected person. In 1H FY12/06A, Shandong Molong sourced RMB71.0m worth of oil well pipe billets and casing billets from Weihai Baolong, representing about 45.3% of the total purchase amount of the products. It is estimated that in FY12/06F, the company sourced

RMB400.0m worth of the products, representing 72.3% of its total purchase amount and 44.0% of its total raw material costs.

Valuation. Currently, the company is trading at EV/EBITDA of 16.2x for FY12/05A. The oil country tubular goods (OCTG) sector is trading at EV/EBITDA of 6.9x for FY12/07F and 6.6x for FY12/08F. The valuation of the sector is still not demanding and a re-rating, especially of Chinese producers, is expected, given the robust earnings outlook.

Table 4: 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	1,438	11.7	8.5	5.5	4.4
Grant Prideco	GRP US	Dec	USD	5,926	11.7	10.1	8.0	7.0
HydriI	HYDL US	Dec	USD	2,045	19.8	16.0	10.9	9.4
Vallourec	VK FP	Dec	EUR	11,764	8.7	8.3	4.8	4.5
Tenaris SA	TEN IM	Dec	EUR	25,018	10.8	6.7	7.3	7.4
Anhui Tianda Oil Pipe	8241 HK	Dec	HKD	331	11.6	9.7	7.3	6.3
Enric Energy Equipment	3899 HK	Dec	HKD	250	19.4	14.2	14.7	10.6
Average					10.8	8.1	6.9	6.6

Source: SBI E2-Capital, Bloomberg

P & L (RMBm)	03A	04A	05A	Cash Flow (HK\$m)	03A	04A	05A
Year to Dec				Year to Mar			
Turnover	302.3	487.7	776.5	EBIT	63.2	69.1	116.9
% chg				Depre./amort.	5.7	9.1	13.4
Gross profit	75.4	96.7	180.4	Net int. paid	3.8	3.5	1.4
EBITDA	68.9	78.2	130.3	Tax paid	(4.8)	(8.1)	(9.5)
Depre./amort.	(5.7)	(9.1)	(13.4)	Dividends received	-	-	-
EBIT	63.2	69.1	116.9	Gross cashflow	67.9	73.7	122.3
Net int. income/(exp.)	(3.8)	(3.5)	(1.4)	Chgs. in working cap.	(15.5)	(29.8)	185.1
Exceptionals	-	-	-	Operating cashflow	52.4	43.8	307.4
Associates	-	-	-	Capex	(53.4)	(55.9)	(223.2)
Jointly-controlled entit.	-	-	-	Free cashflow	(16.6)	(41.9)	269.3
Pre-tax profit	59.3	65.6	115.5	Dividends paid	(5.5)	(10.8)	(21.1)
Tax	(13.2)	(1.5)	(27.3)	Net distribution to MI	-	(7.0)	-
Minority interests	(2.2)	(2.7)	(3.0)	Investments	(6.0)	-	-
Net profit	44.0	61.4	85.2	Disposals	25.6	6.3	0.8
% chg				New shares	-	80.9	100.5
Dividends	-	(18.9)	(24.0)	Others	2.4	(6.5)	(14.6)
Retained earnings	44.0	42.5	61.2	Net cashflow	15.5	50.8	149.8
EPS (HK\$) - Basic	0.109	0.122	0.141	Net (debt)/cash - Beg.	-	7.2	58.0
EPS (HK\$) - F.D.	0.109	0.122	0.141	Net (debt)/cash - End.	7.2	58.0	207.8
DPS (HK\$)	-	0.035	0.037				
No. sh.s o/s (m) - W.A.	405.0	501.3	604.8	Interim Results (RMBm)	05A	06A	
No. sh.s o/s (m) - Y.E.	405.0	540.0	648.0	Six months to Jun			
No. sh.s o/s (m) - F.D.	405.0	540.0	648.0	Turnover	323.9	443.4	
				% chg		36.9	
Margins (%)				Profit from operations	51.2	80.7	
Gross	24.9	19.8	23.2	Interest expenses	(1.7)	(3.8)	
EBITDA	22.8	16.0	16.8	Associates	-	-	
EBIT	20.9	14.2	15.1	Jointly-controlled entit.	-	-	
Pre-tax	19.6	13.4	14.9	Pre-tax profit	49.5	76.9	
Net	14.5	12.6	11.0	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	
Balance Sheet (RMBm)	03A	04A	05A	Shareholding Structure			
Year to Dec					Shares o/s (m)	%	
Fixed assets	93.0	133.3	359.6	Zhang En Rong	279.5	43.1	
Intangible assets	0.0	0.1	0.3	Other domestic shareholders	122.2	18.9	
Other LT assets	-	-	-	Mackenzie Inc.	69	10.6	
Cash	97.2	88.0	257.8	Public	177.3	27.4	
Accounts receivable	55.3	89.9	75.7	Total	648.0	100.0	
Other receivables	59.5	15.6	29.8				
Inventories	68.0	140.3	213.9	Background			
Due from related co.s	10.4	0.0	22.0	Based in Shandong 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.			
Other current assets	-	-	-				
Total assets	383.4	467.1	959.1	Key Ratios	04A	05A	
Accounts payable	(120.3)	(169.1)	(421.2)	Net gearing (%)	Cash	Cash	
Other payable	(47.3)	(20.2)	(38.9)	Net ROE (%)	34.1	26.0	
Tax payable	(6.9)	(0.3)	(23.4)	EBIT ROCE (%)	37.7	31.5	
Due to related co.s	-	(0.8)	(10.6)	Dividend payout (%)	30.8	28.2	
ST debts	(65.0)	(30.0)	(50.0)	Effective tax rate (%)	2.3	23.6	
Other current liab.	-	-	-	Net interest coverage (x)	19.5	83.8	
LT debts	(25.0)	-	-	A/R turnover (days)	54.3	38.9	
Other LT liabilities	-	-	-	A/P turnover (days)	108.3	138.7	
Total liabilities	(264.5)	(220.4)	(544.1)	Stock turnover (days)	97.2	108.4	
Share capital	40.5	54.0	64.8				
Reserves	73.6	191.6	345.4				
Shareholders' funds	114.1	245.6	410.2				
Minority interest	4.8	1.1	4.9				
Total	118.9	246.6	415.1				
Capital employed	90.0	276.6	465.1				
Net (debt)/cash	7.2	58.0	207.8				