

Shanshui Cement



Positive view reinforced

Not Rated

Key points:

- Strong positioning in Shandong and Liaoning, where the market is less competitive
- High market share in Shandong cities, where the pace of development is fast, due to the government's aggressive phasing out of old capacity
- 10-15% of Liaoning's market, where cement demand should outstrip supply in the short term
- Trading at 6.4x FY12/08F and 4.5x FY12/09F P/E, compared with peers' average of 11.2x and 8.0x

Positive view reinforced. Our already positive view on Shanshui Cement (Shanshui) was reinforced after our conference call with the management. Key takeaways are summarized below. For our view on the cement sector, refer to our sector brief *"Looking defensive for 2009" (4 Dec)*.

Industry dynamics

- ❑ Shanshui's market share is estimated at ~33% in Shandong and ~10-15% in Liaoning, its two main operating areas
- ❑ In Shandong, Shanshui's production is located in coastal and central cities, where pace of development is faster. Management estimates that local market share there exceeds 80%
- ❑ We re-iterate our favourable view on Shandong's cement sector in 2009 (esp. 2H 2009), with growth driven by: 1) aggressive elimination of old capacities and 2) infrastructure investment from fiscal stimulus packages of central and provincial governments.
- ❑ Shandong is China's largest cement production region, plagued by old capacity (~50%) and fragmentation (many single production line companies). Since 2007, the government has started to aggressively phase out old capacities driving the price of cement in the region.
- ❑ Shandong's property sector has held up well in 2008, with no significant decline in sales volume. However, 1H 2009 is expected to be weaker, which we expect to have more impact on small cement producers as they typically align themselves with local property developers. This weakness may actually help to accelerate consolidation, working in Shanshui's favour. Meanwhile, an increase in infrastructure projects will benefit scaled players such as Shanshui as they offer better guarantees of production volumes, consistency and quality control. In FY12/08, Shanshui derived about 1/3 sales from the property sector and 1/3 from the infrastructure sector. We expect its FY12/09A sale mix to skew heavily towards the infrastructure sector.
- ❑ The outlook of Liaoning's cement market also appears to be good. The province is one of the few regions in China where demand outstrips supply. At the end of 2007, Liaoning had an

China Infrastructure

Mon, 08 Dec 2008

Kennedy Tsang / Ludovic de Richecour
(852) 2533 3713 / 3708
kennedytsang / ludovic@sbie2capital.com

Stock data

Price	HK\$1.50
Target price	Not Rated
12 mth range	HK\$0.76-3.36
Market cap.	US\$533.6m
Daily t/o, 3 mth	US\$0.569m
Free float %	43.4%
Ticker	0691.HK/691 HK

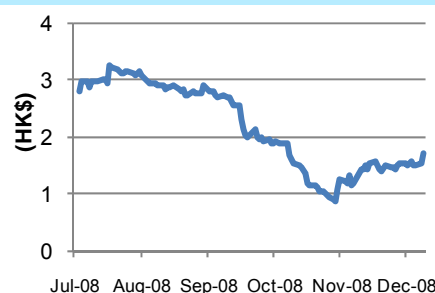
Financial summary

Year to Dec	05A	06A	07A
Turnover (RMBm)	2,800.4	3,500.9	4,144.6
Net Profit (RMBm)	105.8	203.7	214.6
EPS (RMB)	0.05	0.10	0.11
EPS Δ%	NA	100%	10%
P/E (x)	28.0	14.0	12.7
P/B (x)	9.7	5.6	1.1
EV/EBITDA (x)	10.4	8.6	8.8
Yield (%)	0.0	na	na
ROE (%)	na	51.8	14.0
ROCE (%)	na	22.8	11.7
N. Gear. (%)	0.87	0.82	0.59

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	22.5	-21.4	na
Actual price change (%)	28.3	-43.6	na
	08F	09F	10F
Consensus EPS (HK\$)	0.215	0.310	0.415
Previous forecasts (HK\$m)	na	na	na
Previous EPS (HK\$)	na	na	na

Price Chart



overall production capacity of ~50m tonnes (compared with ~160m for Shandong), of which up to 70% was old capacity. This demand/supply imbalance will be even more pronounced going forward after the provincial government announced a RMB1,300t fiscal stimulus package, to be invested over the next 5-10 years.

Operations

- ❑ Cement prices are trending down, from RMB350/t at the beginning of September to RMB318/t at the end of November, as Shandong enters the winter season. The decline should accelerate in December/January. Compared with cement producers with more presence in the south, Shanshui has more seasonality due to the north's harsher winters. It usually takes advantage of this slowdown period to carry out maintenance/upgrades of its production lines.
- ❑ Shanshui currently has a production capacity of 34.0m tonnes (Shandong: 30.0m tonnes, Liaoning: 4.0m tonnes) and plans to increase it to 43.8m tonnes by end-FY12/09F. Capex is expected to be not less than RMB1,100m.
- ❑ We expect the declining coal price to be extremely beneficial to the company since 70-80% of its production cost is related to coal and electricity expenses. While the company typically signs supply contracts with coal suppliers each year, purchase prices are usually floating according to market rates.
- ❑ With its solid market share, the company has a certain level of pricing power. It typically sets cement prices internally, based on its analysis of market demand, competition etc. Its prices are typically RMB20-30/tonne higher than those of other small cement producers.

Competitive landscape

- ❑ Competition in Shandong and Liaoning is less intense than in the south, where regional economies are more developed. Typical of the less developed regions, Shandong and Liaoning have one to two large suppliers and many small producers.
- ❑ Southern provinces such as Guangdong and Henan are very competitive as supply exceeds demand. Cement prices are falling.
- ❑ China United, subsidiary of CNBM (3323 HK, HK\$6.95) is the other large player in Shandong. However, production overlap is not very intense as China United has a stronger presence in southern Shandong.
- ❑ We believe that Sinoma's (1893 HK, HK\$3.81) and CNBM's expansion strategy of acquiring equity interest in cement producers is not efficient given that: 1) they typically hold only a controlling interest; 2) they retain existing management. This makes it more difficult to streamline operations and improve production efficiency, in our view.
- ❑ We believe that the current high cement demand in Sichuan (and high cement prices) driven by post-earthquake reconstruction efforts which prompted key players' aggressive capacity expansion may result in over capacity in a few years.

Valuation. Shanshui is currently trading at 6.4x FY12/08F and 4.5x FY12/09F P/E on based on consensus estimates, compared with peers' average of 11.2x and 8.0x.

Table 1: P&L

Year to Dec (RMBm)	FY12/05A	FY12/06A	FY12/07A	1HFY12/07A	1HFY12/08A
Revenue	2,800.4	3,500.9	4,144.6	1,795.2	3,372.0
Cost of goods sold	(2,315.1)	(2,875.8)	(3,372.9)	(1,476.1)	(2,707.0)
Gross profit	485.2	625.1	771.7	319.1	665.0
Other income (expense)	52.3	82.4	79.9	24.6	22.3
Selling and Marketing Expenses	(125.3)	(126.4)	(156.8)	(78.3)	(85.9)
Administrative Expenses	(150.4)	(190.9)	(262.9)	(104.8)	(235.9)
Profit from operations	261.9	390.2	431.9	160.7	365.6
Finance income	4.9	13.0	41.3	12.7	18.5
Finance expense	(125.3)	(148.1)	(210.1)	(86.7)	(186.5)
Profit before taxation	141.6	255.1	263.1	86.7	197.6
Income taxes	(35.8)	(51.4)	(48.5)	(16.8)	(46.8)
Net income	105.8	203.7	214.6	69.9	150.8

Source: Company data & SBI E2-Capital

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

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

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2008. All rights reserved.