Shanshui Cement

Positive view reinforced

Not Rated

China Infrastructure

Mon, 08 Dec 2008

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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

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

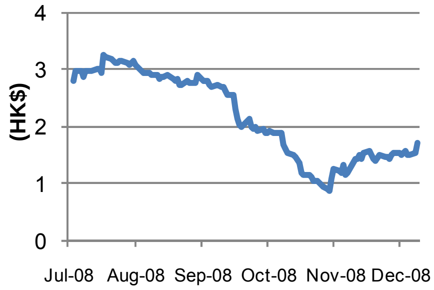
Financial summary

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