Chu Kong Pipe

At the beginning of a bull market

to summarize…

- Chu Kong Pipe released its FY12/12A operating result; turnover was up by 16%, while net profit increased by 34% YoY to RMB310.1m. Reported net profit beat our estimate by 7.9% and consensus forecast by 4.5%.
- 2012A turnover and bottom-line growth was largely attributable to sales growth in 1H 2012A. 2H turnover was down by 9% HoH and 12% below market expectation, despite sales volume increased by 19% HoH.
- Increased sales proportion to domestic regional pipe customers during 2H impacted on group gross margin and per ton gross profit. For 2H 2012A, domestic sales denoted 83% of total sales revenue as opposed to 64% in 1H 2012A, and 48% in full year 2011A.
- Key growth drivers in the next three years would be the acceleration of national pipeline investment under the 12th five year plan, while arsing demand from domestic offshore project, power tower and other appliances would sustain the long term domestic demand for Chu Kong's products.
- We have revised up our target price by 45% to HK$5.49. Our target price implies 12A P/E ratio of 11.5x and 13F P/E ratio of 9.4x.

2012A Result summary. Turnover increased by 16% YoY to RMB3,926m, while gross profit increased by 31% YoY to RMB666.6m with gross margin enhanced by 1.9pp YoY to 17%. Net profit increased by 34% YoY to RMB310.1m with net margin increased by 1.1pp YoY to 7.9%. Bottom-line performance was mostly in line with market expectation. 2012A Net profit of RMB310.1m was 4.5% exceeded market expectation of RMB296.7m and 7.9% above our forecast of RMB289.0m. For 2H 2012A, domestic sales denoted 83% of total sales revenue as opposed to 64% in 1H 2012A, and 48% in full year 2011A. As a result, average gross profit per ton dropped by 25% HoH to RMB1,040/t (gross profit margin was down by 0.6pp HoH to 16.7%), leading gross profit to fall by 10% HoH to RMB299.1m. Base on current share price of HK$3.76, 12A P/E ratio is trading at 9.7x and 12A P/B ratio is trading at 1.2x.

Market outlook and expectation. The market key growth drivers remain intact;1) commencement of the national pipe peak cycle; 2) acceleration of the domestic offshore project development; 3) emerging demand in LSAW for power tower. With gradually release in new production capacity, we expect Chu King will have a record financial result in 2014F and 2015F. Yet, as the closure of the 18th National Congress of the Communist Party of China, the pace of the 12th five year plan execution has been accelerated. Any company announcement of major reward of the national pipe contract will be a strong catalyst to the short run share price. We expect to see major contract reward in 2Q 2013F and 2H 2013F and order to be delivered starting from 2H 2013F. Consequently, 1H 2013F overseas sales will be high as opposed to 2H 2012A, but lower in 2H 2013F.

Maintain BUY with upward adjustment on TP to HK$5.49. We are bullish on the Chu Kong pipe next 2 years performance. In our view, the strong market sentiment might lead to market re-rating in steel pipe industry. Pipe Chu Pipe is well positioned in the uptrend industry. With the bullish market and new production capacity to be in place, sales performance will be strong. We have revised up our target price by 45% to HK$5.49 on 1) approaching the industry up-cycle, 2) +50% increase in production capacity in 2013F, and 3) anticipating cost saving arise from new steel plate processing plate to be construct.

Ticker	1938 HK
Rating	BUY
Price (HK$)	3.76
Target Price (HK$)	5.49 (46%)
12m Price Range (HK$)	1.69 – 4.32
Market cap. (US$m)	487.4
Daily t/o (US$m)	2.1
Free float (%)	30.4

Financial summary

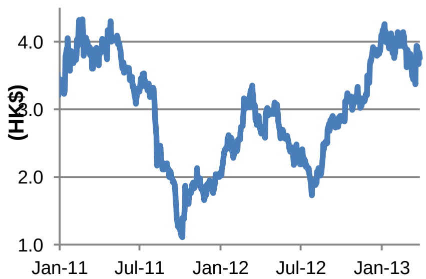
Year to Dec	11A	12A	13F	14F
Turnover (RMBm)	3,377	3,926	5,821	6,948
Net Profit (RMBm)	231	310	380	493
EPS (RMB)	0.23	0.31	0.38	0.49
P/E (x)	13.08	9.70	8.01	6.17
P/B (x) pre-CB	1.38	1.24	1.09	0.95
EV/EBITDA (x)	10.90	9.11	7.19	5.67
Yield (%)	1	2	2	3
ROE (%)	11	13	14	17
ROCE (%)	9	10	11	11
N. Gear. (%)	52	67	81	66

Source: SBI E2-Capital

	13F	14F	15F
Consensus EPS (RMB)	0.4	0.4	-
Previous earnings (RMBm)	415	465	-
Previous EPS (RMB)	0.41	0.46	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	0.6	(0.4)	21.9
Actual price changes (%)	(3.1)	(2.6)	29.7



Source: Bloomberg

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2012A Result summary. Chu Kong Pipe has delivered FY12/12A operating result with bottom line performance was mostly in line with market expectation. 2012A Net profit of RMB310.1m was 4.5% exceeded market expectation of RMB296.7m and 7.9% above our forecast of RMB289.0m. Despite the exceed expectation full year result, 2H 2012A turnover performance was down by 12%/ RMB253.9m than consensus of RMB2,122.4m. The variance between market sales forecast and actual figure was largely attributable to higher than expected domestic sales. For 2H 2012A, domestic sales denoted 83% of total sales revenue as opposed to 64% in 1H 2012A, and 48% in full year 2011A. Since the majority of domestic order being delivered in 2H 2012A was the lower-margin regional pipeline orders, sales turnover, profit margin and average gross profit per ton were impacted.

Three factors to the higher than expected domestic sales. Historically, Chu Kong's domestic and overseas sales ratio is varied roughly between 40% and 60%. The ratio varies on the stages of the national pipeline investment cycle. The 2012A situation was a bit difference from the historical trend. The higher portion of domestic sales for 2012A was due to 3 key factors; 1) finishing the domestic regional pipe orders on hand, 2) enriched LSAW appliances and 3) major overseas steel pipe orders were mostly delivered in 2011A and new orders are to be tendered in 1H 2013.

- **Domestic peak cycle is postponed to 3rd to 5th year under the five year plan.** Discrepancy from the historical trend, domestic steel pipe industry was yet to pick the cyclical uptrend in the 2nd year of the five year plan. Domestic steel pipeline investment cycle largely relies on the national development plan, known as the five year plan. The 12th five year plan (2011 – 2015) investment schedule and execution pace was slow down due to the shift in the National Congress of the Communist Party of China and the National People's Congress in Nov 2012 and in Mar 2013. Upon completion, the execution was reinforced and Government fixed asset investment has been accelerated. Under the expectation, management had decided to complete most domestic city steel pipe order on hand during 2H (lower gross profit per ton).
- **Widened LSAW application to 1) coal slurry transportation and 2) ultra-high voltage power transmission tower**. During 2012, Chu Kong launched its pipeline in coal slurry transportation and ultra-high voltage power transmission tower. In June 2012, company entered into a sales contract to deliver 71,700 tonnes of LSAW pipe for the Shenwei Coal Slurry Project (sales volume accounted for 70% of total project), amounted to total contract value of RMB510.0m. A portion of slurry project order was delivered during 2H 2012A. In terms of power tower, State Grid has decided to use a combination of LSAW steel pipes and ERW steel pipe to construct the high transmission power for higher stability. The project estimates demand up to total 2.7m tonnes of steel pipe valued up to RMB500m. Under the 2H period, Chu Kung delivered roughly 67k tonnes of steel pipe to the project, leading to increase production of ERW under the period.
- **Major steel pipe orders were delivered in 2011**. Key overseas orders were delivered during 2011A, including Peru National Gas project, Western Siberia – Pacific Ocean project and Columbia project. Sales to overseas customer dropped by 39% YoY to RMB1,063.2m. Management expect sales to overseas ratio would restore to ~50% in 1H 2013F, due to major overseas sales tenders were being tendered while new domestic national steel pipe orders are estimated to be delivered mainly in 2H 2013F.

As a result, average gross profit per ton dropped by 25% HoH to RMB1,040/t (gross profit margin was down by 0.6pp HoH to 16.7%) leading gross profit to drown 10% HoH to RMB299.1m, despite increase in sales volume by 19% HoH to 287,635 tones. The decrease in gross profit per ton was partly offset by the high margin (up to RMB2,000/ ton) Husky Deep Sea project being delivered in 2012.

Other income – Government subsidies. Government subsidies contributed roughly 30% of net profit. For the FY12/12A, government subsidies increased by 61%/ RMB36.0m YoY to RMB95.1m in 2012. The increase was due to awards for the investment in Lianyungang and high product quality of company products. We expect the amount of government subsidies will be remained at similar level for 2013F due to substantial expansion plan to be carried during 2013 in the Lianyungang production base (steel plate processing plan, new SSWA production line). For 2012, the adjusted net profit before the government subsidies were RMB215.0m, increased by 25% YoY.

Table 1. Operating result summary

RMBm	11A	1H 12A	2H 12A	% chg HoH	12A
Sales	3,376.9	2,057.5	1,868.5	-9%	3,926.0
- Overseas Sales	1,750.8	744.8	318.5	-57%	1,063.2
- Domestic Sales	1,626.0	1,312.8	1,550.0	18%	2,862.8
% Overseas Sales	51.8%	36.2%	17.0%	-19.2pp	27.1%
% Domestic Sales	48.2%	63.8%	83.0%	+19.2pp	72.9%
Total Sales volume	457,405	240,700	287,635	19%	528,335
Gross profit / tonnes (RMB)	1,110	1,383	1,040	-25%	1,196
Gross profit	507.8	332.9	299.1	-10%	632.1
Gross profit margin	15.1%	17.3%	16.7%	-0.6pp	17.0%
Net profit	230.7	170.3	139.7	-18%	310.1
Net profit margin	6.8%	8.3%	7.5%	-0.8pp	7.9%
Government subsidies	59.0	51.2	43.9		95.1
Adjusted Net profit	171.7	119.1	95.9	-19%	215.0

Source: SBI E2-Capital

Events to be completed after balance sheet date:

The change of the land use right of the Panyu land. Chu Kong has applied for the change of the land use right from industrial use to commercial use in relation to the land located next to the existing production base in Panyu. The land is located at the east of intersection of Cangsha Road and Qinghe Road, Shiji Town in Panyu (next to the Panyu existing production base) with total site area of 125,000m^2 and total permitted construction area of 401,000m^2. The land has been used for temporary storage of the company's steel pipe products. The application was mainly cooperating in concert with the local government redevelopment plan, which the land location is located close by the new town centre to be developed. In order to cope with city development plan, company has entered into contract to apply for the change of land use, despite there is no specific plan yet in developing the land. Based on the contract, the land premium for the change was RMB425.5m. The payment is expected to be paid in 2 instalments, first payment was paid in 1Q 2013A, while the second payment will be paid before the end of 1Q 2014F. Upon completion, the market value of the land will increase from RMB120.0m to RMB2,000.0m as compared to the current book value of RMB26.8m. In our view, the change of the land use right would provide options to utilise the land in the future; hence it is beneficial to the company in the long run. However, the land premium of RMB425.5m might put pressure on company capital, especially under the capacity expansion period. We expect the land premium would mostly finance by bank borrowing, which the incremental finance costs might impact on the financial performance. If we assume average borrowing costs of 5% per annum, 100% bank financing would induce up to RMB21.3m charge to P&L. We expect the change will impact on company B/S in 2013F or 2014F.

Table 2. Historical P&L

RMBm	FY12/10A	FY12/11A	FY12/12A	*FY12/12F*
Revenue	1,681	3,377	3,926.0	*4,153*
% chg	-40%	101%	16%	
COGS	(1,417)	(2,867)	(3,259.4)	*(3,474)*
Gross Profit	264	510	666.6	*680*
Other income and gains	11	69	108.3	*100*
Selling and distribution costs	(43)	(71)	(88.5)	*(87)*
Administrative Expenses	(116)	(166)	(217.3)	*(208)*
Other Expenses	(4)	(3)	(9.4)	*(4)*
Exchange gain/(loss), net	(2)	5	(1.7)	-
Operating profit	155	382	520.5	*564*
EBIT	112	345	458.1	*480*
EBITDA	154	387	518.8	*564*
Interest Expenses	(23)	(65)	(77.4)	*(127)*
Profit before Tax	89	280	380.7	*353*
Income Tax Expense	(19)	(49)	(70.6)	*(64)*
Profit for the year	70	231	310.1	*289*

Source: SBI E2-Capital

Table 3. Historical B/S

RMBm	FY12/09A	FY12/10A	FY12/11A	FY12/12A
Non-Current Assets	880.3	1,270.8	1,945.5	2,946.7
PPE	499.9	1,071.2	1,420.3	2,211.3
Goodwill	11.6	4.4	0.2	5.9
Other	368.9	195.2	525.0	729.5
Current Assets	1,453.9	2,344.5	3,485.2	3,834.1
Inventories	520.2	977.5	1,190.2	807.9
Trade and Bill Recivables	267.2	355.0	803.3	1,385.8
Prepayments and other recivables	116.2	360.9	462.4	480.7
Cash and Bank Balances	349.3	599.2	981.8	1,039.3
Other	201.1	51.9	47.5	120.4
Current Liabilities	999.5	1,344.8	2,464.4	2,586.1
Trade and bills Payables	395.6	204.0	666.6	863.6
Interset-bearing bank loans and other borrowings	293.0	727.0	1,434.8	1,163.3
Other	311.0	413.8	363.0	559.1
Non non current Liabilities	382.8	279.5	768.7	1,734.4
Interset-bearing bank loan and other borrowings	377.0	240.0	732.3	1,636.1
Other	5.8	39.5	36.4	98.3

Source: SBI E2-Capital

Model update:

Forecast update on the proposed steel plate processing plant. We have anticipated the financial impact of the proposed steel processing plant, in the view of higher feasibility. The processing plant will be located near the new Liangyungang production base with designated steel plate annual production capacity of 2m tonnes. Integrating into upstream, company expects the volume will be sufficient to satisfy production demand, and will save up to RMB600/t of steel pipe produced. We assume the plant construction will be completed in 1H 2014F and commence production in 2H 2014F. It is estimated that total CAPEX for steel plate plant amounted up to RMB700m. If we assume 70% of the CAPEX would be financed by long-term bank loan at interest rate 7%, while steel plant can save up to RMB450 per steel pipe, the steel plant processing plant would value (NPV) up to RMB346.8m or equivalent to HK$0.54 per share.

Table 4. The return study on the steel plate processing plant to be constructed

Year	2013	2014	2015	2016
Assumption				
Steel pipe production volume (tonnes)	815,750	970,000	955,000	819,500
Steel plate production volume (tonnes)	-	500,000	955,000	819,500
CAPEX (RMBm)	(350)	(350)		
Discount rate	16%			
Finance Cost	7%			
Tax rate	18%			
Valuation				
Cash save (RMB/t)	450	500	550	600
CAPEX (RMBm)	700	700	700	700
NPV (RMBm)	346.8	462.8	578.8	694.8
Valuation / Share (HK$ per share)	0.54	0.72	0.89	1.07

Source: SBI E2-Capital

2013F CAPEX projection. If we assume the land premium of RMB425.5m would be paid in full in FY2013F, the aggregate CAPEX for 2013F may amount up to RMB1,000m. Key CAPEX items for 2013F include: 1) the land premium, 2) New SSAW production line in Zhuhai, 3) CAPEX in JV at Saudi, 4) New steel plate processing production line.

Table 5. 13F CAPEX

Projects	2013F
Zhuhai SSAW production line	RMB50m
Investment in Saudi JV	RMB150m
New steel plate processing plant	RMB350m
Land premium	RMB542.5m
Total	RMB975.5m

Source: SBI E2-Capital

Table 6 shows our financial projection for the next three years:

Table 6. Our financial projection for the next three years

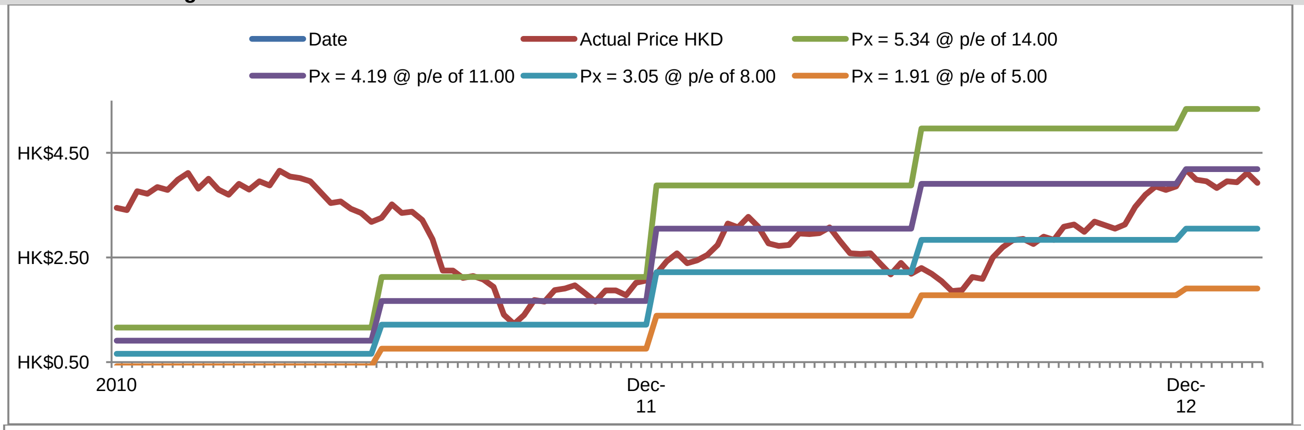
RMBm	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Revenue	3,926.0	5,821	6,948	6,884
COGS	(3,259.4)	(4,874)	(5,801)	(5,370)
Gross Profit	666.6	947	1,147	1,514
Other income and gains	108.3	87	69	34
Selling and distribution costs	(88.5)	(122)	(146)	(145)
Administrative Expenses	(217.3)	(291)	(347)	(344)
Other Expenses	(9.4)	(6)	(7)	(7)
Exchange gain/(loss), net	(1.7)	-	-	-
		-	41	73
Operating profit	520.5	740	915	1,292
EBIT	458.1	615	757	1,125
EBITDA	518.8	740	915	1,292
Interest Expenses	(77.4)	(151)	(162)	(132)
Profit before Tax	380.7	463	594	993
Income Tax Expense	(70.6)	(83)	(101)	(169)
Profit for the year	310.1	380	493	825

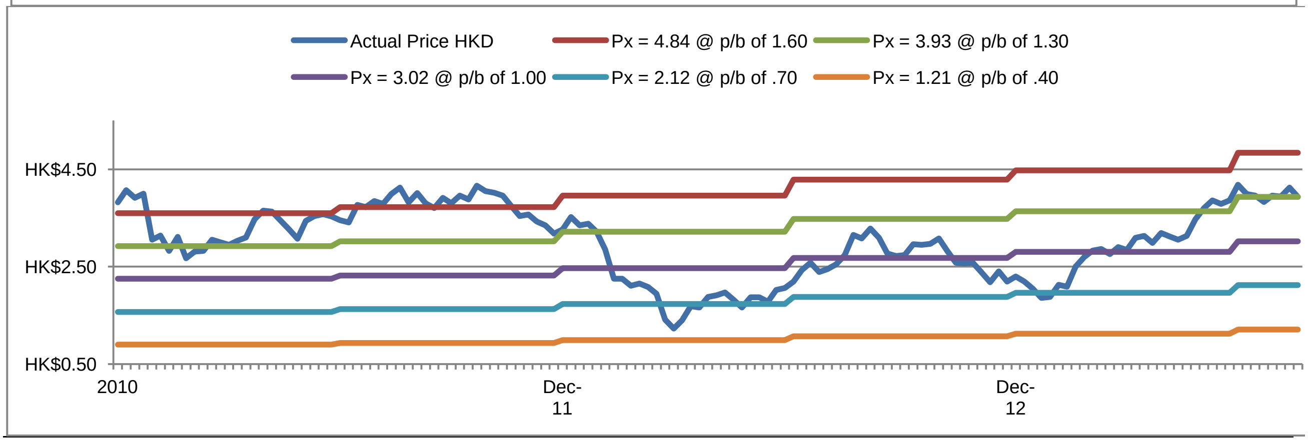
Source: SBI E2-Capital

Market outlook. The key grow drivers remain intact as mentioned in our initial coverage, 1) commencement of the national pipe peak cycle, 2) acceleration of the domestic offshore project development, 3) emerging demand in LSAW for power tower and 4) gradually release in new production capacity in coming two years. As the closure of the 18th National Congress of the Communist Party of China, the pace of the 12th five year plan execution has been accelerated. Some early work on the upcoming key national pipeline projects has been carried out. For instance, the construction work of Kazakhstan part of the Kazakhstan-China Pipeline project II has begun on Dec 2012. Yet, Baosteel (600019 CN), one of the approved LSAW producer, has entered JV agreement with CNPC in Dec 2012 to invest RMB8b for 12.8% equity interest in the JV to develop the West to East Gas Pipeline project III (The estimated CAPEX for the West to East Gas project was RMB116b). It is expected that the demand for steel pipes will reach 50,000km during 2013 to 2015 (demand up to 17.5m tonnes of LSAW). Major national pipeline projects to be completed in 12th five year plan include West-East Pipelines III, the Xinjiang-Guangdong-Zhejiang Pipeline and Xinjiang-Shandong Pipeline. On top of the national pipeline project, State Grid is intended to spend RMB500b during 12th give year plan for the new power tower. The new power tower would demand up to total 2.7m tonnes of LSAW and ERW steel pipe. Yet, new sales contract for coal slurry transmission pipeline as well as potential new application areas, such as wind power, sewage disposal, insulation and oil platform construction would boost the demand for steel pipe products.

Maintain BUY with upward adjustment on TP to HK$5.49. We are bullish on the Chu Kong pipe next 2 years performance. Demand for steel pipe, especially for LSAW and SSAW steel pipe, would reach peak cyclical top mainly due to acceleration of the national pipeline investment. The new arising demand from State Grid and deep-sea pipe would promote the long-term growth exceeds the high-season under the 12th five year plan. For 1H FY12/13A, we do not expect much of delivery of national pipe orders. It is because key national pipeline projects are yet to tender, but to be tendered soon, while commenced projects are mostly constructing in the northern and western regions, which Chu Kong construction base is located in the south-east China. Since the tender of the national pipe project has gradually released, we expect Chu Kong will be rewarded key national pipeline contract as soon as 2Q in 2013F and to be delivered starting from 2H 2013F. As for 1H, we expect the overseas sales will be strong, maybe contribute exceeds 50% of group sales. In our view, with the commencement of the key national pipe construction, the market sentiment will remain strong. In the short term, announcement of major the national pipe projects reward will be a strong catalyst to share price. We have revised up our target price by 45% to HK$5.49 on 1) approaching the industry up-cycle, 2) +50% increase in production capacity in 2013F, and 3) anticipating cost saving arise from new steel plate processing plate to be construct. Table 7 shows the Chu Kong's PE band in the past three years and company valuation base on our financial projection.

Table 7. Bloomberg PE & PB Band





Target Price Valuation (HK$)	FY12/12A	FY12/13F	FY12/14F	FY12/15F
PE @ 8x	3.07	3.76	4.88	8.16
PE @ 11x	4.22	5.17	6.71	11.21
PBE@ 14x	5.37	6.57	8.54	14.27

Source: SBI E2-Capital

Table 8. Implied Multiples of our target price

	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Implied P/B (x)	1.81	1.60	1.39	1.13
Implied P/E (x)	11.47	9.36	7.21	4.31
Implied EV/EBITDA (x)	10.02	7.83	6.19	3.85

Source: SBI E2-Capital

Table 9. Our Target price

Discount Rate	15%	17%	19%
Market cap (RMB)	RMB4,931.3m	RMB4,444.4m	RMB4,072.8m
CNY / HKD	1.25	1.25	1.25
Market cap (HK$)	HK$6,164.2m	HK$5,555.5m	HK$5,091.1m
number of shares	1,011.14	1,011.14	1,011.14
Target price	6.10	5.49	5.03

Source: SBI E2-Capital