Corporate Flash

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Anhui Tianda Oil Pipes: Robust earnings growth

Recommendation: BUY (initiating coverage) China Oil & Gas Equipments & Services

Price	**HK$3.90**
Target price	HK$5.35 (+37.2%)
12 mth range	HK$3.20-4.38
Market cap.	US$254.1m
Daily t/o, 3 mth	na
Free float %	33.0%
Ticker	8241.HK/8241 HK

Year to Mar	Net profit RMBm	EPS RMB	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
04A	74.1	0.926	-	4.2	2.5	72.2	0.3	58.6	34.2	68.3
05A	71.9	0.263	(71.6)	14.9	3.4	17.9	1.6	32.8	22.5	44.4
06F	126.9	0.358	36.4	10.9	2.3	10.3	1.6	21.5	18.1	Cash
07F	225.5	0.444	24.0	8.8	2.0	6.1	2.8	24.0	22.3	Cash
08F	270.0	0.532	19.7	7.4	1.7	5.2	3.4	24.8	24.1	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): na, na, na
Actual price changes (1 mth, 3 mth, 12 mth): na, na, na

Key points:

- The seventh largest oil well pipe manufacturer in China.
- 3-year EPS CAGR is projected to be 26.5% between FY12/05A and FY12/08F.
- Set to benefit from the booming oil exploration industry in China.
- Undemanding valuation at ex-cash P/E of 8.3x for FY12/07F.

Company background. Listed on GEM board in December 2006, Anhui Tianda Oil Pipe was the seventh largest oil well pipe manufacturer in China in 2005. Given its projected strong earnings growth, high earnings visibility of the sector and undemanding valuation, we initiate coverage on this counter with a BUY recommendation.

Oil & gas equipments and services providers: **a better proxy to strong China crude demand.** Unlike E&P companies (oil and gas exploration and production companies), which are highly sensitive to the fluctuation in crude prices and subject to tight control by the government, oil & gas equipments and services providers are at the better position to benefit from the strong demand for crude and gas in China. Their growth prospects are dependent on the expansion in number of E&P projects in China, the growth in the state-owned oil conglomerates' budgeted E&P capex and the demand for crude in the country. China demand for energy is escalating on the back of strong economic growth and rapid urbanization. According to OPEC, China crude demand is estimated to increase by 9.4% YoY to 7.2m barrels per day in 2006. It is projected that China crude demand will increase further to 7.6m barrels per day in 2007, representing an annualized growth rate of 6.3%. Besides, China has been building its strategic crude reserves. The number of E&P projects in the country is expected to increase further on the growing demand. Furthermore, high crude and gas prices has turned oil and gas wells that were considered as dry holes in the past into valuable projects. Between FY12/01A and FY12/05A, PetroChina, Sinopec and CNOOC's capex on E&P increased at a 4-year CAGR of 19.2%, 3.3% and 31.6%, respectively.

Supportive polices. The government has promulgated a series of policies that are supportive to the pipe manufacturing industry in China and favorable to the group. The production of oil well pipes and boiler pipes is regarded as an encouraged segment in steel industry in China by National Development and Reform Commission ("NDRC"). The State Council of PRC intends to increase its support to the research and development of enterprises in the group's operating region, the mid-west China. Furthermore, the group's high value added oil well pipes and petrochemical pipes expansion project has also been designated as part of the 861 Action Plan promoted and supported by the Anhui Provincial Government.

Strong demand for oil well pipes. Oil well pipes are a type of seamless pipes that are used in oil and natural gas exploration activities and cannot be reused. Steel billet is the major raw material of seamless pipe. Between 2001 and 2005, consumption of oil well pipes in China increased at a 4-year CAGR of 9.5% to 2,085 tons from 1,449 tons. Demand for oil well pipes is expected to increase robustly on the back of the expansion in the number of exploration projects in China.

One of the largest oil well pipes manufacturers in China. With the top ten players occupied 99.6% of the market, the oil well pipes production industry in China is concentrated. According to China Iron and Steel

Association, Anhui Tianda Oil Pipe was ranked seventh among oil pipe manufacturers in China in 2005, accounting for of 3.8% of market share in terms of output. With the projected output of 159,600 t.p.a. in 2006, the group is likely to surpass Baogang Group as the fifth largest oil pipe manufacturer in China in this year. Its is worth to note that some of the group's competitors, including Baosteel Group, Anshan Iron and Steel and Baogang Group, are integrated steel producers and suppliers of steel billets. There is a possibility that the group's competitors from the steel industry may increase the raw material prices in order to squeeze the group's and other pure pipe manufacturers' margin. However, it is not likely to happen, in our view, as sales generated from seamless pipes only accounts for small proportion of steel conglomerates' revenues.

Certificated products' quality. The group was awarded the Product Inspection Waiver in December 2005, making it a preferred supplier of many large petrochemical companies in China. The group has been granted the API certification by American Petroleum Institute as well. Besides, the group's production plants have been recognized by national shipping registers such as China Classification Society in China, Det Noske Veritas in Norway, Lloyd's Register in the U.K., Germanischer Noske Veritas in Germany, etc.

Table 1: The top ten oil well pipe producers in China in 2005

Company	Output ('000 t.p.a.)	Market share (%)
Tianjin Pipe (Group)	1,006	41.9
Baosteel Group	500	20.8
Hunan VALIN Steel Tube & Wire	238	9.9
Anshan Iron and Steel	193	8.0
Baogang Group	110	4.6
Pangang Group Chengdu Iron & Steel	95	4.0
Anhui Tianda Oil Pipe	90	3.8
Jiangsu Chengde	60	2.5
Tianjin Seamless Pipe Factory	54	2.3
Jiangsu Xigang Group	44	1.8
Top ten sub-total	**2,390**	**99.6**
Total for China	**2,400**	**100.0**

Source: China Iron and Steel Association

Expanding capacity expansion. Currently, designated production capacity at the group's two manufacturing plants is 300,000 t.p.a.. An additional 50,000 t.p.a. of capacity is expected to be added on its existing capacity, through technological upgrades and production optimization at its current production lines. Output for this fiscal year is projected to be 210,000 t.p.a. We expect the group's output to increase at a 2-year CAGR of 28.2% on the back of the 16.6% increase in production capacity and the robust demand for its products.

Table 2: Capacity and output

	04A	05A	06F	07F	08F
Production capacity (t.p.a.)	25,000	200,000	300,000	325,000	350,000
Output: oil well pipes (t.p.a.)	256	94,063	159,600	244,000	276,000
Output: petrochemical pipes (t.p.a.)	5,595	6,643	8,400	15,250	17,250
Output: other specialized seamless pipes (t.p.a.)	17,266	27,805	42,000	45,750	51,750
Total output (t.p.a.)	23,116	128,510	210,000	305,000	345,000
Utilization rate (%)	92.5	64.3	70.0	93.8	98.6

Source: Company data, SBI E2-Capital

Margin enhancement. HK$101.0m (21.8%) of the net proceeds raised from the group's IPO in December is earmarked for the installation of threading and heat processing line with production capacity of 100,000 t.p.a.. The new line is expected to commence operation by 1H FY12/07F. Currently, the group sells semi-finished products to its client (mostly oilfield engineering companies), and the users must modify the pipes to cater for the requirements of different wells. When the new processing line commences operation, the group can offer customized finished products to its customers according to their unique specifications. This should lead to margin enhancement. Proportion of oil well pipes in the total output is expected to increase from to 80.0% in FY12/07F from 73.2% in FY12/05A. The proportion of revenue derived from the sales of self-produced oil well pipes in the group's total manufacturing division's revenue is expected to increase to 77.7% in FY12/07F from 69.5% in FY12/05A. Since oil well pipes command a gross profit margin of approximately 21.0%, higher than the group's overall blended margin of 19.8%, the increase in sales of oil well pipes would lift up the group's overall profit margin. Last but not least, better economy of scale and production yield would enhance gross profit margin further. In fact, gross profit margin of oil well pipes increased from 18.4% in FY12/05A to 21.4% in 1H FY12/06A, due to better economy of scale and improved production yield. Although petrochemical pipes command the highest gross profit margin among the group's product categories, petrochemical pipes are highly customized product and cannot be produced in large scale. Thus, we only expect a limited contribution from the sales of petrochemical pipes.

Table 3: Gross profit margin by product types (manufacturing division)

Gross profit margin (%)	04A	1H05A	05A	1H06A	06F	07F	08F
Oil well pipes	8.9	15.5	18.4	21.4	20.8	21.4	21.7
Petrochemical pipes	19.8	15.1	21.4	24.8	24.7	25.1	25.4
Other specialized seamless pipes	13.2	11.0	15.0	13.5	14.9	15.4	15.7
Over all gross margin	14.8	14.2	17.8	19.9	19.8	20.6	20.9

Source: Company data, SBI E2-Capital

Growth momentum beyond 2009. The group plans to develop a 300,000 t.p.a. capacity to produce high grade oil well pipes. It existing oil well pipes are catered for oil well with a depth of approximately 3,000 meters or less. Compared with the group's existing products, high-grade oil well pipes are more heat-resistant and anti-corrosive. It can be applied to the offshore wells, deep wells and artic wells. The proposed project has been classified as a part of the 861 Action Plan of Anhui Province. Nevertheless, the application for the proposed project is pending for approval from the authorities. Sales of high-grade pipes can potentially be a new source of revenue to the group. Besides, demand for high-grade pipe is expect to increase robustly going forward, since the mining companies will increase exploration in offshore and Western China, as resources lay in Eastern China have been depleting. Last but not least, high-grade pipes are expected to command a gross profit margin higher than that of the group's existing oil well pipes, given its sophistication. However, we do not include the new capacity in our earning forecasts at this juncture, as the new capacity is still pending for approval from the authorities.

Revenue model and earnings forecasts. The group is engaged in the manufacturing, trading and sales of oil well pipes, petrochemical pipes and other specialized seamless pipes. Revenue derived from manufacturing and trading division accounted for 77.7% and 22.3% of the group's total revenue in 1H FY12/06A, respectively. The overall blended profit margin of the group's trading division was 12.2% in 1H FY12/06A. Growth momentum in the group's earnings between FY12/05A and FY12/08F will be fueled by the organic growth in demand for oil well pipes, capacity expansion and margin enhancement. We project the group's EPS to increase at a 3-year CAGR of 26.5% between FY12/05A and FY12/08F. Acquisitions and the planned high-grade oil well pipes production capacity can serve as the earnings catalysts going forward. On the back of the strong earnings growth, we projected that the group's free cash flow would increase at a 3-year CAGR of 110.2%, from HK$33.6m to HK$312.3m, between FY12/05A and FY12/08F.

Valuation and recommendation. We are positive on the outlook of the oil & gas equipments and services provision sector in China, given China growing appetite for energy, national oil conglomerates' vigorous financial position and their aggressive capex plan on exploration and production projects, and relative high crude prices. Share price of Shandong Molong (8261 HK, NR), the counterpart of the group, has leaped 92.9% YoY. The stellar price performance of Shandong Molong indicates the sector has grabbed investors' attention. Thanks to the booming oil exploration and production industry in China, Shandong Molong's revenue and net profit increased at a 4-year CAGR of 49.8% and 64.9% between FY12/01A and FY12/05A, respectively. At the closing price of HK$3.90, Anhui Tianda Oil Pipe is trading at an undemanding ex-cash P/E of 6.5x for FY12/07F, compared with the sector average P/E of 12.1x for FY12/07F. Based on the sector P/E of 12.1x for FY12/07F, we set our target price on the counter at HK$5.35, representing an upside potential of 37.2%. Given its robust EPS growth, high earnings visibility in the sector and undemanding valuation, we initiate coverage on Anhui Tianda Oil Pipe with a BUY recommendation.

Table 4: Peer group comparisons

Company name	Ticker	Year End	Currency	Price	Market cap (US$m)	P/E (x) FY06F	P/E (x) FY07F	P/E (x) FY08F
Lone Star Technologies	LSS US	Dec	USD	49.5	1,531	13.6	11.2	9.0
Grant Prideco	GRP US	Dec	USD	41.3	5,291	12.4	10.5	9.0
Hydril	HYDL US	Dec	USD	75.9	1,693	20.6	17.0	13.2
Vallourec	VK FP	Dec	EUR	221.8	15,527	12.5	10.6	10.1
Tenaris SA	TEN IM	Dec	EUR	19.1	29,757	15.7	12.9	11.8
Shandong Molong	8261 HK	Dec	HKD	2.7	227	15.0	9.7	8.5
Average						***14.5***	***12.1***	***11.0***

Source: Bloomberg

Institutional holding. Based on the disclosure of interests posted on the web site of HKEX on Dec 27, 2006, Baring Asset Management, Hillhouse Capital Management, Northern Trust Fiduciary Services, Atlantis Investment Management, GLHH Fund II and Credit Agricole Asset Management own 4.2%, 4.6%, 3.9%, 3.2%, 3.3% and 2.2% interests in the group, respectively.

P & L (HK$m)	04A	05A	06F	07F	08F
Year to Mar					
Turnover	**333.6**	**906.6**	**1,389.9**	**1,951.6**	**2,215.0**
% chg	-	*171.7*	*53.3*	*40.4*	*13.5*
Gross profit	45.6	144.2	250.1	369.0	423.6
EBITDA	28.9	117.5	194.9	328.0	383.3
Depre./amort.	(1.7)	(17.1)	(25.3)	(34.2)	(35.0)
EBIT	27.2	100.4	169.6	293.8	348.3
Net int. income/(exp.)	(2.6)	(3.9)	2.2	11.0	16.5
Exceptionals	(0.0)	(0.3)	(0.3)	0.0	0.0
Associates	(0.0)	(0.0)	(0.0)	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**24.6**	**96.3**	**171.5**	**304.8**	**364.9**
Tax	49.5	(24.4)	(44.6)	(79.2)	(94.9)
Minority interests	-	-	-	-	-
Net profit	**74.1**	**71.9**	**126.9**	**225.5**	**270.0**
% chg	-	*(3.0)*	*76.6*	*77.7*	*19.7*
Dividends	(0.9)	(17.0)	(31.7)	(56.4)	(67.5)
Retained earnings	73.2	54.8	95.2	169.2	202.5
EPS (HK$) - Basic	0.926	0.263	0.358	0.444	0.532
EPS (HK$) - F.D.	0.926	0.263	0.250	0.444	0.532
DPS (HK$)	0.011	0.062	0.063	0.111	0.133
No. sh.s o/s (m) - W.A.	80.0	273.6	354.2	507.6	507.6
No. sh.s o/s (m) - Y.E.	80.0	273.6	507.6	507.6	507.6
No. sh.s o/s (m) - F.D.	80.0	273.6	507.6	507.6	507.6
Margins (%)					
Gross	*13.7*	*15.9*	*18.0*	*18.9*	*19.1*
EBITDA	*8.7*	*13.0*	*14.0*	*16.8*	*17.3*
EBIT	*8.2*	*11.1*	*12.2*	*15.1*	*15.7*
Pre-tax	*7.4*	*10.6*	*12.3*	*15.6*	*16.5*
Net	*22.2*	*7.9*	*9.1*	*11.6*	*12.2*

Balance Sheet (HK$m)	04A	05A	06F	07F	08F
Year to Mar					
Fixed assets	217.2	241.5	289.2	348.4	327.2
Intangible assets	-	-	-	-	-
Other LT assets	58.3	39.0	56.4	35.6	13.4
Cash	3.6	12.7	627.5	721.9	984.9
Accounts receivable	8.1	22.2	23.2	32.6	37.0
Other receivables	46.9	30.0	-	-	-
Inventories	27.9	131.4	119.1	165.3	187.1
Due from related co.s	-	108.8	108.8	108.8	108.8
Other current assets	-	-	-	-	-
Total assets	**361.9**	**585.6**	**1,224.1**	**1,412.7**	**1,658.4**
Accounts payable	(24.5)	(45.9)	(54.0)	(75.8)	(86.0)
Other payable	(76.6)	(116.8)	(174.4)	(241.5)	(273.2)
Tax payable	(0.9)	(0.9)	(15.5)	(54.7)	(99.6)
Due to related co.s	(43.4)	(0.8)	-	-	-
ST debts	(25.0)	(25.0)	(75.0)	(3.0)	(16.0)
Other current liab.	-	-	-	-	-
LT debts	(65.0)	(85.0)	(35.0)	(32.0)	(16.0)
Other LT liabilities	-	-	-	-	-
Total liabilities	**(235.5)**	**(274.3)**	**(353.9)**	**(407.0)**	**(490.8)**
Share capital	40.0	170.0	672.7	672.7	672.7
Reserves	86.5	141.3	197.5	332.9	494.9
Shareholders' funds	**126.5**	**311.3**	**870.3**	**1,005.6**	**1,167.6**
Minority interest	-	-	-	-	-
Total	**126.5**	**311.3**	**870.3**	**1,005.6**	**1,167.6**
Capital employed	216.5	421.3	980.3	1,040.6	1,199.6
Net (debt)/cash	(86.4)	(97.3)	517.5	686.9	952.9

Cash Flow (HK$m)	04A	05A	06F	07F	08F
Year to Mar					
EBIT	27.2	100.4	169.6	293.8	348.3
Depre./amort.	1.8	18.5	25.3	34.2	35.0
Net int. paid	2.6	3.9	(2.2)	(11.0)	(16.5)
Tax paid	(8.8)	(5.2)	(30.0)	(40.0)	(50.0)
Dividends received	-	-	-	-	-
Gross cashflow	**22.8**	**117.6**	**162.7**	**277.0**	**316.8**
Chgs. in working cap.	(5.6)	(31.9)	106.2	33.3	15.7
Operating cashflow	**17.2**	**85.7**	**268.9**	**310.3**	**332.5**
Capex	(26.1)	(51.4)	(72.9)	(93.5)	(13.8)
Free cashflow	**(8.9)**	**34.3**	**196.0**	**216.8**	**318.7**
Dividends paid	(0.9)	(17.0)	(31.7)	(56.4)	(67.5)
Net distribution to MI	-	-	-	-	-
Investments	-	-	-	-	-
Disposals	-	-	-	-	-
New shares	-	-	454.7	-	-
Others	(76.7)	(28.1)	(4.2)	9.0	14.9
Net cashflow	**(86.4)**	**(10.9)**	**614.8**	**169.3**	**266.1**
Net (debt)/cash - Beg.	-	(86.4)	(97.3)	517.5	686.9
Net (debt)/cash - End.	(86.4)	(97.3)	517.5	686.9	952.9

Interim Results (HK$m)	05A	06A
Six months to Sep		
Turnover	**390.6**	**596.1**
% chg	-	*52.6*
Profit from operations	34.9	82.6
Interest expenses	(2.9)	(1.5)
Associates	(0.0)	(0.0)
Jointly-controlled entit.	-	-
Pre-tax profit	**32.0**	**81.1**
Tax	(11.6)	(27.6)
Minority interests	-	-
Net profit	**20.4**	**53.4**
% chg	-	*162.5*
EPS (HK$) - Basic	0.080	0.160
DPS (HK$)	0.068	0.167

Shareholding Structure	Shares o/s (m)	%
Tianda Holding & Tianda Inv	340.0	67.0
Public	167.6	33.0
Total	**507.6**	**100.0**

Background

Listed on GEM board in Dec 2006, Anhui Tianda Oil Pipe was the seventh largest oil well pipe manufacturer in China in 2005. The group's product portfolio consists of two main categories: the specialized seamless pipes for the oil and natural gas industry and other specialized seamless pipes include vessel pipes and boiler pipes.

Key Ratios	04A	05A	06F	07F	08F
Net gearing (%)	68.3	44.4	Cash	Cash	Cash
Net ROE (%)	58.6	32.8	21.5	24.0	24.8
EBIT ROCE (%)	12.6	31.5	24.2	29.1	31.1
Dividend payout (%)	1.2	23.7	25.0	25.0	25.0
Effective tax rate (%)	(201.2)	25.3	26.0	26.0	26.0
Net interest coverage (x)	10.5	25.9	na	na	na
A/R turnover (days)	8.9	6.1	6.0	5.2	5.7
A/P turnover (days)	26.9	14.2	13.1	12.1	13.3
Stock turnover (days)	35.4	38.1	40.1	32.8	35.9

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