

## One-stop asphalt sales service

## China Industrials

### Shanghai Donghua (8251 HK, HK\$1.17)

### Not Rated

**Company background.** Shanghai Donghua (“The company”) provides one-stop asphalt sales and logistic services. Asphalt is the company’s sole product and it is mainly sold to road construction companies. The company’s logistic operation involves asphalt delivery by motor vehicles, ocean carriers, inland river carriers and storage of asphalt by tanks. Donghua accounted for over 70% of market share in Shanghai’s road construction business, while Shanghai accounted for one third of its turnover. The remaining 30% market share is dominated by state-owned enterprises.

**Business model.** Donghua adopts one-stop asphalt sales and one-stop logistics service in order to minimize cost and enhance operating efficiency. Currently, the company has 10 asphalt storage hubs in operation with a total storage capacity of 110,000 tons. The company will make off-season purchase so it needs to have sufficient storage capacity in order to optimize the inventory level and cost efficiency. The company locates the storage hubs in fast growing cities along the Yangtze River near dock and depot. It also operates own vessels and vehicle fleets in order to cut transportation costs. Currently, the company manages 34 asphalt delivery vehicles and 7 asphalt delivery vessels with a total loading capacity of 18,946 tons.

**Cost of sales.** The company’s cost of sales comprises mainly the purchase cost of asphalt. 40% of the asphalt is purchased from overseas, the company believes that going forward, it will import more asphalt, as overseas market prices are cheaper than that of the local. Every year, the company purchases approximate 350,000 to 400,000 tons of asphalt. One third of that is purchased from CNOOC. The company’s average purchase cost of asphalt has increased by c.25% to RMB1,821 per ton this year when compared to 2004. Note that, the price of asphalt is highly correlated with the price of oil. Donghua has a 5% interest in a CNOOC owned Petrochemical Plant in Taizhou, which supplies 200,000 tons of asphalt to Donghua every year.

**Table 1: 3Q FY12/06 results**

9 months to Sep	Turnover (RMBm)	Gross profit (RMBm)	Net profit (RMBm)	EPS (RMB)
3Q FY12/06	738.9	79.6	51.8	0.076
3Q FY12/05	445.6	63.2	32.1	0.047
YoY chg (%)	65.8	25.9	61.4	61.7

Source: Company data

**Placement and open offer.** The company placed 175m new H shares (representing c.20.33% of the enlarged issued share capital of the company) at an issue price of HK\$1.10 per share to CLSA Capital Partners last month. Recently, the company proposed an open offer (rights issue) of 17.2m offer shares to H shareholders at an offer price of HK\$1.10 per offer share, on the basis of 3.65 offer shares for every 10 existing H shares.

**Lucrative market.** Entry barrier for road construction market is not high, but expanding into this market is relatively hard. According to the China National Highway Network Plan, China will construct additional 34 highways before 2020, thus it is foreseen that consumption of asphalt will increase in the near future. This lucrative market is well dominated by the local governments, thus good relationship with the local governments is very important in determining the success in further extending the market to achieve more scale.

**Possible acquisition.** Currently, the company is in talks with a road construction company in Nantong, Jiangsu. The reason behind this acquisition is to develop road construction business along with the company’s expansion in asphalt business. This road construction company is believed to have strong financial track record, thus this acquisition will provide synergy to the company. The deal is expected to be concluded in the beginning of next year.

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**Prospect.** The company will continue to focus on expanding its asphalt business and expects move upstream into the sales of fuel oil. Going forward, the company will establish new storage hubs in Jiangsu province and Guangxi province. Besides that, it will also expand its markets to Guangxi, Shandong and Ziangsu province. 4Q FY12/06 results are expected to be better than 3Q FY12/06 as the ASP for asphalt has stabilized. Gross profit is expected to improve slightly. Turnover is expected to grow at the rate of 30% every year going forward.

**Valuation.** The counter is currently trading at c.11x FY12/06 P/E and at c.8x FY12/07 P/E (based on the 30% growth in turnover).