

## Looking defensive for 2009

### Key points:

- Despite weakness in cement prices in 2H 2008, the industry has a defensive outlook for 2009, with the government's infrastructure investment led fiscal stimulus package, industry consolidation and domestic oriented qualities
- Industry is regionalized and selected cement producers may further benefit from local government stimulus packages
- We profile the key HK-listed players within the cement sector
- Key players in the sector has rallied between 15-60% since the announcement of the fiscal stimulus package. We think that Shanshui Cement (691 HK, HK\$1.57) is a laggard in this run up, with solid fundamentals and favourable valuation

### China Infrastructure

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**Defensive outlook for 2009.** China's cement sector, despite weakness in cement pricing 2H 2008 caused by the deterioration of the country's slowing property market and overall economy, is set to pick up in 2Q 2009 thanks to industry consolidation, government fiscal policies and moderating raw material prices. Though stock prices for the key players in the sector has rallied 15-60% since the announcement of the central government's fiscal stimulus package, the sector does have a defensive outlook for 2009 given its exposure to both infrastructure and rural area development. On a sector-wide basis, we think investors should overweight the sector on any market weakness.

**Benefits from the stimulus package.** The sector is almost an entirely domestic industry and therefore less vulnerable to the global economic slowdown on the demand side. It is a direct beneficiary of the central government's RMB4,000t fiscal stimulus package, which focuses on infrastructure and rural investment (railway, roads and hospitals etc) and support for China's property sector. According to media reports, the package may boost cement demand by 6.7%, 7.6% and 8.4% in 2009-2011, based on an estimated demand of 1.4b tonnes for 2008.

**Additional benefits from local stimulus packages.** The industry is regionalized due to the bulk size and high transportation costs of cement. Therefore, specific cement companies will reap additional benefits from local government stimulus packages, which are gradually being rolled out. For example, the Jilin Provincial Government announced its fiscal stimulus package of RMB400b, to be invested over five years. Averaged out over the five-year investment period, this represents around 15.3% of Jilin's 2007 GDP. Shanxi and Sichuan announced similar packages which represent 22.8% and 57.1%, respectively, of their 2007 GDP (Sichuan's high average is due to massive post-earthquake reconstruction efforts). With details of the packages yet to be released, it is difficult to quantify the exact increase in FAI budgets but we believe that combined investments of central and local governments will allow provinces and cities such as Sichuan, Shandong, Liaoning and Chongqing to maintain or beat their historical FAI growth trends.

**Consolidating industry.** In Jan-Oct 2008, China's total cement production reached 1.13b tonnes, up 3.6% YoY. Though the growth is mild, the government is actively promoting the industry's consolidation to increase the annual output of the country's top 10 cement enterprises from 13.3% in 2005 to 30.0% in 2010.

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To this effect, the government's policies include:

- encouraging the set up of less polluting/more efficient new dry process (NPD) facilities and the closure of small-scale (in particular less efficient vertical kilns) cement producers;
- setting targets for each province for the closing down of small scale cement production facilities. Between 2004-2006, around 85m tonnes of old capacity was phased out and according to Cement China, around 43m tonnes have been phased out in the first ten months of 2008;
- identifying (in 2007) 12 national cement enterprises to enjoy priority consideration in project investment, mergers and reorganization and 48 other key large cement producers to enjoy government support.

**Declining coal prices to provide margin relief.** Coal is a key cost of production as it is an input to power and operate the clinker and cement production process. With coal prices down some 40% to RMB640-660/tonnes since July, margin pressure should ease into 2009, when cement producers enter new yearly agreements with their respective coal suppliers.

**Table 1: Profile of key HK-listed cement players**

Company name	Ticker	Key areas	Positives	Negatives
Anhui Conch (cement)	914 HK	Central, eastern and southern China	<ul style="list-style-type: none"> <li>▪ China's largest cement producer</li> </ul>	<ul style="list-style-type: none"> <li>▪ Exports around 12% of output - may be affected by the global economic slowdown</li> <li>▪ 65% of sales from south and eastern China, which has borne the brunt of the economic and property slowdown</li> <li>▪ Adjusts its domestic pricing strategy, sacrificing ASP to sustain sales volume</li> </ul>
CNBM (integrated materials)	3323 HK	Eastern and southern central China	<ul style="list-style-type: none"> <li>▪ Cement accounts for 60% of revenue (1H FY12/08A)</li> <li>▪ Gradually moving to centralized coal procurement, to generate some cost savings and margin support</li> </ul>	<ul style="list-style-type: none"> <li>▪ Highly leveraged - net gearing at 216% (1H FY12/08A)</li> <li>▪ Weak demand in Zhejiang, while competition in Hunan and Jiangxi intensifying</li> <li>▪ Not a pure cement play. Segments such as lightweight building materials may be more vulnerable to the weak property sector</li> </ul>
Sinoma (integrated materials)	1893 HK	North and north western China	<ul style="list-style-type: none"> <li>▪ Cement and cement equipment business account for 69% of revenue (1H FY12/08A)</li> <li>▪ Cement demand more robust in north and northwest China</li> <li>▪ Access to Xinjiang allows sourcing of cheaper coal</li> </ul>	<ul style="list-style-type: none"> <li>▪ Not a pure cement play. Glass fibre and high tech materials together account for 31% of revenue</li> <li>▪ 79% of the RMB29.4b cement equipment and engineering services contracts signed in 1H FY12/08A are overseas contracts. This may suffer from softening global demand</li> </ul>
Shanshui Cement (cement)	691 HK	Shandong, Liaoning	<ul style="list-style-type: none"> <li>▪ Regional play - Shandong and Liaoning display steady economic growth</li> <li>▪ Competition less intensive in this area</li> <li>▪ Second largest cement producer after Anhui Conch</li> </ul>	<ul style="list-style-type: none"> <li>▪ Less profitable due to lower cement prices in Shandong/Liaoning</li> </ul>
Asia Cement (cement)	743 HK	Sichuan, central Yangtze, Jiangxi, Jiangsu	<ul style="list-style-type: none"> <li>▪ Exposure to Sichuan earthquake reconstruction efforts</li> </ul>	<ul style="list-style-type: none"> <li>▪ Relatively small scale cement producer</li> <li>▪ Intensifying competition in Jiangxi</li> <li>▪ Weak cement pricing in Jiangsu and Jiangxi due to weak property sector</li> </ul>
Shui On Const. (diversified)	983 HK	Sichuan, Chongqing, Guizhou, Yunnan	<ul style="list-style-type: none"> <li>▪ Through 45%-owned JV with Lafarge, world's largest cement producers</li> </ul>	<ul style="list-style-type: none"> <li>▪ Cement represents only 14% of profit before tax (1H FY12/08)</li> <li>▪ High exposure to China's property sector through its substantial construction segment</li> </ul>
TCC International (cement)	1136 HK	Southern and eastern China	<ul style="list-style-type: none"> <li>▪ Gradual transition to residual heat power generation should lead to cost savings</li> <li>▪ Production capacity expansion coming off a lower base relative to leaders</li> </ul>	<ul style="list-style-type: none"> <li>▪ Smaller scale than peers</li> <li>▪ Southern and eastern China has borne the brunt of the economic and property slowdown</li> <li>▪ production capacity not concentrated regionally</li> </ul>

Source: Company data, SBI E2-Capital

**Table 2: P&L comparison (1H FY12/08A)**

6-mths to June (RMBm)	914 HK	1893 HK	3323 HK	743 HK	691 HK	983 HK	1136 HK
Revenue	10,197.6	10,898.3	9,823.9	1,347.7	3,372.0	1,336.0	1170.3
Gross profit	2,814.7	1,936.3	1,795.3	432.3	665.0	(9.0)	170.7
Operating profit	2,015.7	961.8	1,386.5	285.1	365.6	262.0	128.0
Net profit	1,304.4	295.2	545.5	171.8	155.1	878.0	54.4
EBITDA	2,697.0	1,325.4	1,909.6	454.4	597.3	266.0	250.0

Source: Company data

**Table 3: Margin comparison (1H FY12/08A)**

6-mths to June (%)	914 HK	1893 HK	3323 HK	743 HK	691 HK	983 HK	1136 HK
Gross margin	27.6	17.8	18.3	32.1	19.7	n/a	14.6
Operating margin	19.8	8.8	14.1	21.2	10.8	19.6	10.9
Net margin	12.8	2.7	5.6	12.7	4.6	65.7	4.6
EBITDA margin	26.4	12.2	19.4	33.7	17.7	19.9	21.4

Source: Company data

**Table 4: Main province/city exposure of HK-listed cement producers**

Company name	Package (RMBb)	2007 GDP (RMBb)	% of GDP# (%)	914 HK	1893 HK	3323 HK	743 HK	691 HK
Beijing	135.0	900.6	3.0		*	*		
Tianjin	16.5	501.8	0.7					
Heilongjiang Province	60.0	707.7	1.7					
Jilin Province	400.0	522.6	15.3					
Liaoning Province	1,300.0	1,102.2	23.6	*		*		*
Hebei Province	588.9	1,386.4	8.5		*	*		
Shaanxi Province	26.0	537.0	1.0			*		
Shandong Province	800.0	2,588.8	6.2			*		*
Shanghai	500.0	1,200.1	8.3	*				
Sichuan Province	3,000.0	1,050.5	57.1				*	
Shanxi Province	650.0	569.6	22.8					
Jiangsu Province	650.0	2,556.0	5.1	*	*		*	
Anhui Province	389.0	734.6	10.6	*			*	
Hubei Province	59.7	915.0	1.3				*	
Hunan Province	120.0	914.5	2.6	*	*	*	*	
Zhejiang Province	350.0	1,863.8	3.8	*		*	*	
Chongqing	800.0	411.2	38.9					
Guangdong Province	2,370.0	3,067.4	15.5	*		*		
Guangxi Province	77.8	588.6	2.6	*				
Fujian Province	340.0	916.0	7.4	*			*	
Hainan Province	207.0	123.0	33.7					

# Local government stimulus packages to be invested over 5 year period

Source: Company data, News sources

**Our view.** Key players in the cement sector has rallied between 15-60% since the announcement of the fiscal stimulus package. Within the sector, we think that Shanshui Cement (691 HK, HK\$1.57) is a laggard in this run up, with solid fundamentals and favourable valuation. Meanwhile, we think that after a 65% run up, valuation of CNBM (3323 HK, HK\$6.65) is looking a little stretched. Our reasons are summarized in Table 4.

Table 5: SBI E2-Capital view

	Favourable valuation	Stretched valuation
Company	China Shanshui Cement	CNBM
Ticker	691 HK	3323 HK
Mkt Cap (US\$m)	533.1m	1,672.3m
Consensus valuation	<ul style="list-style-type: none"> <li>▪ P/E: 6.5x FY12/08F, 4.6x FY12/09F</li> <li>▪ EV/EBITDA: 5.2x FY12/08F</li> </ul>	<ul style="list-style-type: none"> <li>▪ P/E: 9.0x FY12/08F, 7.0 FY12/09F</li> <li>▪ EV/EBITDA: 9.6x FY12/08F</li> </ul>
Fundamentals	<ul style="list-style-type: none"> <li>▪ Good risk-to-reward in our view. One of China's largest producers and the largest in Shandong. Valuation at a 39.2% and 39.5% discount to peers despite its scale and exposure to high growth provinces</li> <li>▪ At end-1H FY12/08A, company had net gearing of 135.2%, but company IPOed In July 08 raising HK\$1.8b. We estimate that net gearing would reduce to 75-85%</li> <li>▪ Lower margins than other pure play cement plays chiefly due to the fact that cement prices in Shandong and Liaoning are lower than the national average. However, the cement price is rising fast in Shandong (at end-Oct, up ~41% YoY and ~39% YTD, among the highest rates in China according to Digital Cement and China Cement)</li> <li>▪ GDP of Shandong and Liaoning grew 14.3% and 14.5% in 2007, above the national average of 11.4%</li> <li>▪ Closure of small vertical kilns in Shandong is accelerating, In Feb 2008, the provincial government issued guidelines with an aim to close 66m tonnes of small kilns by 2010</li> <li>▪ Provincial government's stimulus package in Liaoning appears to be aggressive. It should spur demand and offset aggressive production capacity in the region</li> </ul>	<ul style="list-style-type: none"> <li>▪ Though headline P/E numbers look cheap compared to industry leader Anhui Conch (15.7x FY12/08F and 13.3x FY12/09F P/E), its 9.6 x FY12/08F EV/EBITDA valuation basis is similar to Anhui Conch (9.7x FY12/08F EV/EBITDA)</li> <li>▪ High gearing (net gearing at 216% at end-1H FY12/08A). The current tight credit conditions may force it to scale back capex plans undermining future growth</li> <li>▪ More exposure to Zhejiang, where cement prices are pressured due to over capacity, and south China, where the dramatic slowdown in exports may have a big impact on the local economy. At end-1H FY12/08A, 51.4% of cement revenues came from southern China</li> <li>▪ Guangdong's infrastructure is relatively strong and cement market quite competitive</li> </ul>

Source: Bloomberg, SBI E2-Capital

Table 6: Province/city exposure of HK-listed cement producers

Company name	Ticker	Mkt cap (US\$m)	Last Price (Local)	Cur Est P/E (x)	Nxt Est P/E (x)	Cur EV/EBITDA (x)	Est ROE (x)	Net Grg (%)
<b>HK-listed</b>								
Anhui Conch	914 HK	7,049.2	HK\$31.00	15.7	13.3	9.7	19.1	19.1
CNBM	3323 HK	1,894.6	HK\$6.65	9.0	7.0	9.6	15.8	216.0
Sinoma	1893 HK	1,713.9	HK\$3.72	15.1	9.4	4.6	12.8	12.1
China Shanshui	691 HK	547.0	HK\$1.57	6.5	4.6	5.2	15.5	135.2
Asia Cement	743 HK	762.9	HK\$3.80	12.0	8.4	6.8	8.1	40.3
TCC Int'l	1136 HK	271.4	HK\$1.64	5.9	2.6	n/a	9.4	50.2
Average				10.7	7.6	7.2		
<b>China-listed</b>								
Tangshan Jidong	000401 CH	1,867.4	RMB10.59	24.3	15.5	11.5	9.2	132.5
Xinjiang Tianshan	000877 CH	497.7	RMB10.97	15.8	12.3	8.4	27.0	155.5
Ningxia Saima	600449 CH	467.3	RMB16.47	15.2	12.9	7.3	15.5	36.6
Jilin Yatai	600881 CH	1,278.3	RMB6.96	5.9	11.0	n/a	20.5	65.9
Huaxin Cement	600801 CH	743.0	RMB15.16	14.0	10.1	7.1	11.4	133.5
Jiangxi Wannianqing	000789 CH	317.8	RMB5.52	20.4	7.6	n/a	n/a	55.4
Average				15.9	11.6	8.6		

Source: Bloomberg

**Table 7: Share price performance**

(%)	914 HK	1893 HK	3323 HK	691 HK	743 HK	1136 HK	983 HK
Price chg (YTD)	-54.4	-78.2	-61.2	-43.9 <sup>##</sup>	-23.2 <sup>##</sup>	-80.9	-85.3
Price chg (since 07 Nov 08 <sup>#</sup> )	14.8	64.8	47.0	30.8	61.7	67.3	-18.4

# Last trading day before announcement of fiscal stimulus package

## Shanshui Cement (691 HK) IPO on 3 July 2008, Asia Cement (743 HK) IPO on 19 May 2008

Source: Bloomberg

**Table 8: 12 priority national companies identified by NDRC****Company name**

Anhui Conch Cement Co. Ltd. (914 HK)
Shanshui Cement Group (691 HK)
Zhejiang Leomax Group
Huaxin Cement (600801 HK)
Tangshan Jidong Cement (000401 HK)
China United Cement Corporation (subsidiary of CNBM (3323 HK))
Jilin Yatai (Group) Ltd. (600881 HK)
China National Materials Group Corporation (parent co. of Sinoma (1893 HK))
BBMG Group Co. Ltd.
Henan Tianrui Group Corporation
Hongshi Holding Group Co. Ltd.
Gansu Qilianshan Cement Group Co. Ltd. (600720 CH)

Source: Company data

**Table 9: 10 largest cement producers (2007)**

Company name	Production vol (m tonnes)
Anhui Conch Cement Co. Ltd. (914 HK)	81.0
Shanshui Cement Group (691 HK)	27.0
China United Cement Corporation (subsidiary of CNBM (3323 HK))	26.1
Huaxin Cement (600801 HK)	21.2
TCC Int'l (1136 HK)	17.6
Tangshan Jidong Cement (000401 HK)	17.5
BBMG Group Co. Ltd.	15.7
Zhejiang Leomax Group	14.6
LSOC (JV between Lafarge and Shui On Construction (983 HK))	13.4
Hongshi Holding Group Co. Ltd.	12.9

Source: Company data, SBI E2-Capital, China Building Material Council