

JPM-pp1

Asia Pacific Equity Research

22 March 2015

China Shenhua Energy - H (1088 HK)

Neutral

Price: HK\$20.05

20 Mar 2015

Price Target: HK\$24.00

PT End Date: 31 Dec 2015

2014 results in-line; weak 2015 likely to see Street downgrades

Shenhua's FY14 net profit of RMB38.7bn (-14% y/y) was in line with its preliminary results. However, its sharply lower 2015 targets – implying FY15 pretax profits should fall 37%, along with a downbeat assessment of coal markets – suggests material Street downgrades ahead. Near-term, we see valuation support from its declared FY14 dividend of RMB0.74/share, implying a dividend yield of 4.6%. That said, FY15 dividends should also fall accordingly (implied yield 3.1%) based on Shenhua's 40% payout policy. We are Neutral rated.

- FY14 results in-line with guidance.** Shenhua's FY14 net profit of RMB38.7bn (-14% y/y) was in line with its preliminary results announcement (NP RMB38.5bn) announced a month ago. Revenue declined 12% y/y to RMB248bn as a result of lower coal sales (-12% y/y), coal ASP (-10% y/y) and power output dispatch (-5% y/y). The key positives, in our view, were **a) solid cost performance** with reduced unit coal cost (-3% y/y) and unit power output dispatch (-7% y/y), **b) improved profit mix** with non-coal (Power, Rail and Port and Coal to Chemicals) now accounting for 59% of pretax profits, versus 50% in 2013, and **c) strong FCF of RMB23bn**, pushing net gearing (ND/E) lower to 15.2% (2013 15.6%). That said, non-coal pretax profits (+5% y/y) were not sufficient to cushion against lower Coal earnings (-27% y/y), resulting in a 12% decline in overall pretax profits. Meanwhile, Shenhua declared a final DPS of RMB0.74/share, implying a little reduced full-year payout ratio of 38% (FY13: 40%).
- 2015 guidance for a 37% fall in pre-tax profits.** Shenhua provided a downbeat outlook statement, noting that China's slower economic growth, structural change in energy consumption pattern (reduced fossil fuel mix and national energy intensity) alongside coal oversupply will keep coal prices under pressure. The company reiterated its lower 2015 business targets and capex plans announced [earlier](#) (tabled below). On production, Shenhua expects commercial coal output to fall by 11% y/y (coal sales -10% y/y) but power output is targeted to rise by 7%. On P/L items, the company expects a 15% fall in revenues (implies coal ASP to fall -6% y/y), cost of sales to fall by 10% and SG+A and finance costs to rise by 18% y/y. Capex is forecast to fall by 18% to Rmb37B, with 82% devoted to the Power and Transport segment (coal capex 13% of total).
- Sharp consensus downgrades cuts ahead.** By our estimates, Shenuha's guidance points to a 37% y/y fall in pretax to RMB38.7bn, 27% below the Street's RMB53.2bn. This suggests sharp consensus downgrades ahead, even accounting for Shenhua's conservative guidance history (2014 NP actual 15% above guidance). We estimate FY15 dividend could fall to RMB0.50/share based on Shenhua's FY15 financial guidance.

Stock impact

- We see sharp earnings downgrade ahead but near-term valuation support from its declared FY14 dividend (implied yield 4.6%).

Investor Briefing

Shenhua will host an investor briefing in Hong Kong. Full details below:

Date: 23 March 2015 (Monday)

Time: 9:30am – 11:00am

Venue: Atrium, 39/F, Island Shangri-la Hong Kong, Pacific Place, Supreme Court Road, Central, HK

Language: Putonghua, English

Table 1: Shenhua FY15 business targets

| | 2014 target | Actual 2014 | Actual versus guidance | Guidance 2015 | Yoy Chg |
|--|-------------|-------------|------------------------|---------------|---------------|
| Commercial coal production | 305.4 | 306.6 | 0% | 273.6 | -10.8% |
| Coal sales | 444.4 | 451.1 | 2% | 404.3 | -10.4% |
| 3rd party coal | 139.0 | 144.5 | 4% | 130.7 | -9.6% |
| Power output dispatch | 200.0 | 199.4 | 0% | 212.8 | 6.7% |
| Revenues | 245.7 | 248.4 | 1% | 210.0 | -15.4% |
| Cost of revenues | 181.0 | 174.8 | -3% | 156.3 | -10.6% |
| Gross Profit (implied) | 64.7 | 73.5 | 14% | 53.7 | -27.0% |
| SG+A and net finance costs | 13.5 | 12.7 | -6% | 15.0 | 17.7% |
| Others | 0.0 | (0.2) | 0% | 0.0 | -100.0% |
| Pre tax profit (implied) | 51.2 | 60.9 | 19% | 38.7 | -36.5% |
| Income tax (at 2014 tax rate) | 9.8 | 12.6 | 28% | 8.0 | -36.5% |
| Minorities (at 2014 %) | 7.6 | 9.7 | 27% | 5.6 | -41.8% |
| Net profit (implied) | 33.7 | 38.7 | 15% | 25.1 | -35.2% |
| Capital Expenditure (RMBbn) – Assume 2014 target | 48.6 | 44.8 | -8% | 36.9 | -24.1% |
| ASP (implied) | 553 | 551 | 0% | 519 | -5.6% |
| Unit costs (implied) | 407 | 388 | -5% | 387 | -0.2% |
| GP/t (implied) | 146 | 163 | 12% | 133 | -18.5% |
| SG+A/t (implied) | 30 | 28 | -7% | 37 | 31.3% |
| EBT/t (implied) | 115 | 135 | 17% | 96 | -29.1% |

Source: Company data, J.P. Morgan estimates

Table 2: Shenhua 2014 results (IFRS)

| Profit and loss (RMB mils) | QoQ | | | | 2013 | YoY% | | | | 2014 | YoY% | YoY% | |
|-------------------------------|----------------|----------------|----------------|----------------|-----------------|----------------|----------------|----------------|----------------|-----------------|-------|-------|------|
| | Q113 | Q213 | Q313 | Q413 | | 1Q14 | 2Q14 | 3Q14 | 4Q14 | | | | |
| Total revenues | 60,994 | 67,668 | 71,041 | 84,094 | 283,797 | 60,929 | 68,268 | 61,245 | 57,918 | 248,360 | -5% | -31% | -12% |
| Total cost | -41,031 | -45,642 | -51,821 | -63,937 | -202,431 | -41,888 | -47,213 | -44,644 | -41,098 | -174,843 | -8% | 36% | 14% |
| Gross Profit | 19,963 | 22,026 | 19,220 | 20,157 | 81,366 | 19,041 | 21,055 | 16,601 | 16,820 | 73,517 | 1% | -17% | -10% |
| SG & A | -2,105 | -2,118 | -2,286 | -3,609 | -10,118 | -2,067 | -1,943 | -2,228 | -3,221 | -9,459 | 45% | 11% | 7% |
| Others | -282 | -555 | -906 | -577 | -2,320 | -774 | -793 | -267 | -3,113 | -3,113 | 1066% | -440% | -34% |
| Other op expense | 243 | -373 | -54 | -536 | -720 | 70 | -153 | 141 | -291 | -233 | nm | 46% | 68% |
| Sub-total SG&A | -1,862 | -2,491 | -2,340 | -4,145 | -10,838 | -1,997 | -2,096 | -2,087 | -3,512 | -9,692 | 68% | 15% | 11% |
| Net op profit | 18,101 | 19,535 | 16,880 | 16,012 | 70,528 | 17,044 | 18,959 | 14,514 | 13,308 | 63,825 | -8% | -17% | -10% |
| Financing costs | -609 | -701 | -546 | -332 | -2,188 | -893 | -1,022 | -226 | -1,149 | -3,290 | 408% | -246% | -50% |

| | | | | | | | | | | | | | |
|---------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|-------|-------|------|
| Investment income | 0 | 338 | -338 | 0 | 0 | 0 | 293 | -293 | 0 | 0 | -100% | nm | nm |
| Profits of assocs | 84 | 181 | 32 | 291 | 588 | 49 | 89 | 111 | 161 | 410 | 45% | -45% | -30% |
| Profit before tax | 17,576 | 19,353 | 16,028 | 15,971 | 68,928 | 16,200 | 18,319 | 14,106 | 12,320 | 60,945 | -13% | -23% | -12% |
| Tax | -3,129 | -3,714 | -3,368 | -3,493 | -13,704 | -2,804 | -4,062 | -2,972 | -2,724 | -12,562 | -8% | 22% | 8% |
| Profit after tax | 14,447 | 15,639 | 12,660 | 12,478 | 55,224 | 13,396 | 14,257 | 11,134 | 9,596 | 48,383 | -14% | -23% | -12% |
| MI | -2,375 | -2,416 | -2,974 | -2,380 | -10,145 | -2,317 | -2,561 | -2,486 | -2,330 | -9,694 | -6% | 2% | 4% |
| Net profit | 12,072 | 13,223 | 9,686 | 10,098 | 45,079 | 11,079 | 11,696 | 8,648 | 7,266 | 38,689 | -16% | -28% | -14% |
| EPS (Rmb) | 0.607 | 0.665 | 0.487 | 0.508 | 2.266 | 0.557 | 0.588 | 0.435 | 0.365 | 1.945 | -16% | -28% | -14% |
| DPS (Rmb) | | | | | 0.91 | | | | | 0.74 | | | |
| Ratio | | | | | | | | | | | | | |
| Gross profit | 33% | 33% | 27% | 24% | 29% | 31% | 31% | 27% | 29% | 30% | 2pps | 5pps | 1pps |
| Net OP profit | 30% | 29% | 24% | 19% | 25% | 28% | 28% | 24% | 23% | 26% | -1pps | 4pps | 1pps |
| Profit before tax | 29% | 29% | 23% | 19% | 24% | 27% | 27% | 23% | 21% | 25% | -2pps | 2pps | 0pps |
| Profit after tax | 20% | 20% | 14% | 12% | 16% | 18% | 17% | 14% | 13% | 16% | -2pps | 1pps | 0pps |
| Tax rate | 18% | 19% | 21% | 22% | 20% | 17% | 22% | 21% | 22% | 21% | 1pps | 0pps | 1pps |
| Dividend payout | | | | | 40% | | | | | 38% | | | |
| Cash flow analysis | | | | | | | | | | | | | |
| Operating CF | 13,963 | 4,820 | 17,570 | 17,935 | 54,288 | 6,035 | 26,046 | 30,489 | 4,941 | 67,511 | -84% | -72% | 24% |
| Investing CF | -5,846 | -14,241 | -8,531 | -19,155 | -47,773 | -5,020 | -13,237 | -11,545 | -13,361 | -43,163 | 16% | 30% | 10% |
| Capex | -7,974 | -13,576 | -10,555 | -19,043 | -51,148 | -5,723 | -12,159 | -11,849 | -14,537 | -44,268 | 23% | 24% | 13% |
| FCF | 5,989 | -8,756 | 7,015 | -1,108 | 3,140 | 312 | 13,887 | 18,640 | -9,596 | 23,243 | nm | -766% | 640% |

Source: Company data, J.P. Morgan estimates

Investment Thesis

China Shenhua Energy (Shenhua) is China's largest coal miner with world class coal assets and integrated infrastructure and power assets. The company reported resilient FY13 earnings with coal and non-coal businesses providing equal EBIT contributions. While the company's integrated model provides shields the company from the current oversupply in coal markets, Shenhua is not immune. For 2015, the company guides for lowered volume, persistent cost inflation and higher capex, which we estimate implies a 35% fall in FY14 profits.

Valuation

Our Dec-15 price target for Shenhua-H is HKD24.00. This is based on a blended average of: 1) PB-ROE valuation of HKD18.05 (assuming 1.0x PBV), 2) HKD28.2 using a EV/EBITDA multiple of 7.1x, 3) HKD26.6 using a PE multiple of 11.5x and 4) DCF-based NPV of HKD24.6.

Risks to Rating and Price Target

Upside risks to our rating and price target include:

- Stronger-than-expected coal prices and power tariffs
- Lower-than-expected unit cost/capex
- Faster-than-expected additions in coal production and power generation

Downside risks include:

- Weaker-than-expected coal prices and power tariffs
- Higher-than-expected cost pressure/capex

- Slower-than-expected additions in coal production and power generation

Asia Metals and Mining

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|-----------|--------|--------------------|---------------------|
| 24-Jan-07 | OW | 19.90 | 21.00 |
| 11-May-07 | OW | 21.25 | 25.00 |
| 08-Jun-07 | OW | 25.10 | 31.00 |
| 26-Jul-07 | OW | 31.40 | 36.50 |
| 24-Aug-07 | OW | 31.45 | 35.00 |
| 25-Sep-07 | OW | 45.80 | 50.90 |
| 30-Jan-08 | OW | 42.55 | 52.90 |
| 17-Mar-08 | OW | 36.15 | 47.60 |
| 13-Jun-08 | OW | 31.65 | 43.40 |
| 20-Jun-08 | OW | 32.50 | 42.60 |
| 02-Sep-08 | OW | 26.35 | 38.10 |
| 23-Sep-08 | N | 22.00 | 23.40 |
| 29-Oct-08 | N | 10.00 | 15.00 |
| 25-Nov-10 | N | 33.00 | 31.50 |
| 16-Dec-10 | N | 31.20 | 33.50 |
| 08-Oct-11 | OW | 30.80 | 40.00 |
| 30-Oct-11 | OW | 36.20 | 43.50 |
| 29-Apr-12 | OW | 34.45 | 42.00 |
| 20-May-12 | OW | 28.65 | 36.00 |
| 20-Aug-12 | OW | 30.25 | 35.00 |
| 26-Jun-13 | OW | 21.55 | 30.00 |
| 02-Aug-13 | OW | 22.55 | 28.00 |
| 14-Oct-13 | OW | 23.50 | 26.50 |
| 31-Mar-14 | N | 22.40 | 24.00 |

<http://gps-app.emea.jpmchase.net:6080/server/console/chart/?shareClassId=503779&shareClassServerId=4&chartDesignation=1&actionType=C>

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