

JPM-pp1

Asia Pacific Equity Research

23 March 2015

Sinopec Shanghai Petchem - H (338 HK)

Underweight

Price: HK\$2.56

20 Mar 2015

Price Target: HK\$1.50

PT End Date: 31 Dec 2015

Chinese refining/chemicals downturn to persist; guiding capex up 50% in 2015

With SPC having already issued a profit warning for FY14 (see [note](#)), the company's reported net loss of Rmb692mn should not come as too much of a surprise to the market. SPC's 2015 outlook is cautious on the domestic Chinese market with refining overcapacity and chemical imports likely to persist and we are surprised by the company's spending plans. SPC's profitability continues to take a back seat with the shares' c13% absolute outperformance YTD (HSI up c3%) driven more by A-H share technicals, a trend which is difficult to see reversing based on the current A-H spread, in our view.

- **Profitability remains a challenge q/q:** SPC's 2H14 net loss was driven mainly by some inventory loss in refining, lower oil product/chemicals volumes, some losses from associates and other non-operating items. However, refining margins have recovered sharply recently and with reasonably robust chemicals margins for some products, 1H15 is likely to see some profitability improvement, in our view.
- **Aromatics/polyester chain to remain oversupplied:** As we have highlighted previously (see [here](#)) oversupply in aromatics continues in China with Zhejiang Yuandong Petrochemicals having announced it will cease PTA production (3.2mtpa) end 1Q15. The shutdown will impact the local PX market, as it takes c100K tons per month of PX demand. Zhejiang Zhongjin Petrochemical looks to bring online 1.6mtpa capacity beginning in May, further driving the oversupply of PX in Asia.
- **Capex plan up 50% y/y:** FY14 capex was Rmb1.09bn for FY14, within guidance of Rmb1.0-1.2bn given at interims (cut from original plan of Rmb2.0bn), and SPC's capex target is Rmb1.6bn for FY15.
- **Cautious outlook – lower prices; overcapacity:** The company seems to be guiding a more cautious outlook in 2015, stating “possible risks to future expansion” despite its higher spending guidance. The company expects oil prices to remain low this year and sees a slowdown in the domestic market. Overcapacity remains in refining, while chemicals production is challenged from lower cost imports. Interestingly, SPC also suggests that tighter environmental regulations may present further challenges to business development.

Table 1: SPC 2H14 IFRS earnings

RMB m	2H13A	1H14A	2H14A	y/y	h/h
Operating profit					
Synthetic fibres	(325)	(290)	(292)	(10%)	1%
Resins and plastics	(142)	(263)	(69)	(52%)	(74%)
Intermediate petrochemicals	359	59	73	(80%)	22%
Petroleum products	1,565	558	(588)	NM	NM
Trading of petrochemical products	99	26	40	(60%)	53%
Others	148	96	61	(59%)	(36%)
Total operating profit	1,705	187	(775)	NM	NM
Net financing charge & other income	89	(314)	12		
Pretax Profit	1,794	(127)	(762)	NM	498%
<i>Taxation</i>	(212)	7	207		
<i>Tax rate, %</i>	12%	5%	27%		
Net income	1,582	(121)	(555)	NM	360%
<i>Minority Interest</i>	(6)	(3)	(13)		
Adj. net income	1,576	(124)	(569)	NM	360%

Source: J.P. Morgan estimates, Company data.

Table 2: SPC 2H14 operating statistics

metric tons	2H13	1H14	2H14	h/h	y/y
Refining Throughput	7,960,500	7,225,700	6,944,500	(4%)	(13%)
DGK	4,623,300	4,251,200	4,173,100	(2%)	(10%)
Gasoline	1,489,900	1,514,700	1,355,800	(10%)	(9%)

Diesel	2,416,400	2,033,300	2,032,000	(0%)	(16%)
Jet Fuel	716,900	703,200	785,300	12%	10%
Ethylene	474,600	404,700	399,700	(1%)	(16%)
Paraxylene	482,300	364,600	316,000	(13%)	(34%)
Synthetic fibre monomers	428,700	361,700	344,200	(5%)	(20%)
Synthetic fibre polymers	258,700	204,700	212,300	4%	(18%)
Synthetic fibres	125,200	116,900	115,500	(1%)	(8%)

Source: Company reports.

Table 3: SPC 4Q14 China GAAP earnings

	4Q13	3Q14	4Q14	y/y	q/q
Operating Profit / (Loss)	429	(129)	(1,089)	NM	741%
Non-Operating Exp	608	141	333		
Pretax Income	1,036	11	(756)	(173%)	NM
Income Tax	(36)	5	202		
Income Before XO Items	1,000	16	(554)	NM	NM
MI	(1)	(4)	(10)		
Net Income (Ex-MI)	999	13	(564)	NM	NM

Source: J.P. Morgan estimates, Company data.

Figure 1: SPC net income vs. Theoretical China GRMs



Source: J.P. Morgan estimates, Company data. Note: Quarterly net income is reported in China GAAP.

Figure 2: Polyethylene spreads



Source: Bloomberg.

Figure 3: Polypropylene spreads



Source: Bloomberg.

Figure 4: Olefin spreads



Source: Bloomberg.

Figure 5: Polyester chain spreads



Source: Bloomberg.

Investment Thesis

Sinopec Shanghai Petrochemical is one of the largest integrated refining and petrochemical companies in China. It is a subsidiary of Sinopec Corp (386 HK). It produces refined oil products, intermediate, petrochemicals, synthetic resins and synthetic fibers. The company recently completed the 6th Phase expansion and upgrading program which increases its effective refining capacity to 16mn ton/yr from 12 mn ton/yr. Shanghai Petrochemical is currently capable of producing gasoline meeting Euro V (similar to China standards), and diesel of Euro IV and Euro V qualities. Key points to our negative view include:

- **Limited view on capex spending** – While the company has cut its Rmb2.0bn capex spending in FY14 to Rmb1.2bn, we remain unclear on if the cut is merely a delay of project spending to be pushed into FY15 (we model Rmb2.0bn capex in FY15). High capex spending in chemicals capacity limits free cashflow.
- **Weakness in petrochemicals to continue; limiting refining upside** – With petrochemicals pricing weak going into 2015 and limited improvements forecasted, we believe that the commodity chemical segments will remain a drag on SPC's earnings.

Valuation

Our Dec-15 PT of HK\$1.5 is based on DCF. We have applied a WACC of 11.2% and perpetual growth rate of 2% in our DCF calculations.

Risks to Rating and Price Target

Risks to our price target include improving petrochemicals pricing, better-than-expected improvements in GRM's on the shift to higher spec gasoline/diesel, asset injections from Sinopec, and the A-H share through-train program shrinking the discount of SPC's H-share listing vs A-shares.

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Date	Rating	Share Price (HK\$)	Price Target (HK \$)
17-Sep-13	OW	1.92	2.47
24-Oct-13	OW	1.95	2.50
14-Apr-14	UW	2.11	2.00
29-Apr-14	UW	1.90	1.70
11-Jul-14	UW	2.27	1.60
29-Sep-14	UW	2.60	1.80
09-Nov-14	UW	2.43	1.50

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