

JPM-pp1

Asia Pacific Equity Research

23 March 2015

# Hilong Holdings Ltd. (1623 HK)

## Overweight

Price: HK\$2.44

25 Feb 2015

Price Target: HK\$3.20

PT End Date: 31 Dec 2015

Cautiously optimistic; top line growth, but margin pressure

*Hilong's management update provided a cautiously optimistic outlook for the business with the company suggesting the domestic market should not deteriorate more than 2014. Revenue guidance is mid-to-high single digits, but Hilong concedes that there may be some margin pressure at the net line. A concern is offshore engineering gross margin guidance, which has gone from 40% to now 20% (which makes it one of the lowest margin segments). We remain OW Hilong on a relative basis within our oil service coverage with recent management guidance essentially in line with our recent adjustments (see note [here](#)).*

- **Sharply lower capex:** Hilong's capex guidance is cRmb150mn in 2015 (from Rmb1.3bn last year).
- **Rationale for Russian coating acquisition:** Russia coating acquisition related to Hilong's intention to control the marketing as the company felt the partner was not focusing on this business line.
- **Margin on offshore revised down ... again:** The company now guides offshore engineering gross margins at 20% from 40% at the time of acquisition and preparation. Focus of international offshore expansion is South East Asia; still negotiating for more offshore contracts.
- **Linepipe business – revenue recovery:** Lower FY14 domestic activity in line pipes was offset by more international business which supported margins in the segment. Hilong believes that Sinopec and PetroChina/ CNPC will increase spending on linepipe safety and inspection in the medium term, and management expects revenue to return to 2013 levels (Rmb365mn in FY13 vs Rmb272mn in FY14).
- **Non-API mix stable in drillpipe:** The fall in drillpipe volumes domestically related to fewer purchases from SOEs post the anti-corruption issues and reorganization of the OFS arms (e.g. SSC). The company forecasts a pickup in domestic volumes this year. Internationally, 2014 was a good year in management's view with the biggest contributor an increase in the Americas, although Hilong sees a fall in international volumes in 2015. Overall in 2014, non-API is still c30% of total sales and Hilong expects to remain at this level medium-term.
- **Oilfield services – rig cancellation risks:** Fleet utilization is 85% and two rigs may be up for renewal in 2H15, although the high-spec rig market (e.g. 2,000/3,000 HHP rigs) will remain stable, in management's view. Hilong has not received any suspension notices. Margin declines in FY14 for the OFS segment relate to a higher contribution from OTCG trading, which is a lower margin business, albeit growing.
- **Outlook remains uncertain, hence lower payout:** While Hilong provided a relatively upbeat outlook, the company still cut its dividend payout which reflects the current market risk according to the company.

### Investment Thesis

Hilong Group provides drill pipes (both AP and non-API), coatings and oilfield services to the oil industry in China and internationally. The company is broken down into three operating segments: drill pipes, coatings and oilfield services. The firm has operations in most of China's onshore fields and is increasingly focusing offshore, as well as on international markets, particularly the US. Our positive view on Hilong is based on:

- **Improving product mix; leverage to increasing field complexity:** We see Hilong repositioning its drill pipe products toward non-API "tailor-made"; non-API products provide higher margins (>40% gross margin) than standard API products (typically 35-40%).

• **High-margin and integrated oil services offering:** We see Hilong’s oilfield services segment as an important growth driver for the company that integrates other parts of the group’s segments, where margins are competitive with both local and international oil service names; additional capacity will also help to drive growth. We note the segment conducts only international operations and has not been effected by the domestic slowdown in China.

• **Prudent expansion; upside from offshore business:** The firm’s new pipe-laying barge (cUS\$164mn with capacity up to 300m underwater) is high spec, with operations beginning in FY15 to be an earnings driver.

## Valuation

Our Dec-2015 price target of HK\$3.20/share is derived from a sum-of-the-parts methodology, with each of Hilong’s business segments valued using an EV/EBITDA multiple. Find below the breakdown of SOTP valuation:

Segment	EBITDA (Rmb in millions)	EV/EBITDA	EV
Drill pipes	144	6.0	864
Coatings	172	7.0	1,203
Oilfield services	615	6.0	3,690
<b>Total</b>	<b>931</b>		<b>5,756</b>
Net (Debt) / Cash			(1,485)
Equity value			4,272
NOSH			1,696
Fair Value (Rmb)			2.5
Price Target (HK\$)			<b>3.2</b>

Source: J.P. Morgan estimates.

## Risks to Rating and Price Target

Key risks to our rating and price target include increased competition lowering margins, slowdowns in the domestic tendering process, US anti-dumping laws and overpaying for new assets.

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Date	Rating	Share Price (HK\$)	Price Target (HK \$)
09-Mar-14	OW	5.80	7.00
24-Mar-14	OW	4.25	6.30
25-Aug-14	OW	4.29	6.00
09-Nov-14	OW	2.83	3.60
15-Feb-15	OW	2.47	3.20
23-Mar-15	OW	1.95	2.90

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