Hilong Holdings Ltd.

Stable margins; payout cut; coating/offshore to offset challenges in drillpipe

Overweight

1623.HK, 1623 HK

Price: HK$1.95

▼ **Price Target: HK$2.90**
Previous: HK$3.20

China

Asia Oils

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Hilong's 2H14 adjusted net income was below market estimates, but essentially in line with us. The miss seems to be driven by lower revenue in its line pipe business, and with the company highlighting "unfavourable market conditions" in its core segments, only partly offset by the contribution from its new offshore business this year, we believe the results will be taken slightly negatively by the market. However, we still see Hilong as more defensive across the energy value chain and remain OW on a relative basis within our oil service coverage.

- **Drillpipe deliveries in line:** Hilong reported 2H14 net income of Rmb218mn, up 22% h/h (vs consensus at Rmb175mn) with lower line pipe revenue offset by strong performance in oil equipment/services. Drillpipe pricing still shows a downward trend, although FY14 volumes were up 14% y/y and directed toward overseas (61% of total vs c40% for the period FY09-13).

- **Offshore barge progressing:** Hilong is progressing with its two contracts from CNOOC including one in the East China Sea and the other in the South China Sea (riser connections, mid-May); the contracts imply cRmb550mn in revenue and may contribute >Rmb600mn in the medium term.

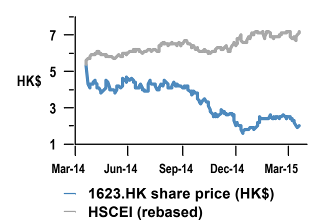
- **Cash conversion disappointing:** Cash conversion cycle was weaker in 2014 (c240 days vs c230 days FY13), mostly on growing inventory days (up c25 days) and slowing receivables conversion period (up c20 days).

- **Dividend proposed, but cut payout:** Hilong has proposed a HK$0.05 cash dividend, although payout was only 17% relative to 29% in FY13.

- **Moving away from China; increasing exposure to Russia:** Hilong acquired the remaining interest in Hilong Temerso (Russian coating business, previously held a 56% stake). Revenue exposure to Russia (incl Central Asia/E.Europe) was 11% in FY14 (vs 9% in FY13), while China has fallen from 50% to 35%.

- **Reducing EPS FY15/17 by c9%; new PT HK$2.90:** We have revised down our EPS FY15/17 on average by 9% pa to reflect 2H results and weaker drillpipe market in FY15/16; we revise our Dec-15 PT to HK$2.90 (from HK$3.20).

Price Performance



	YTD	1m	3m	12m
Abs	7.7%	-23.8%	11.4%	-64.0%
Rel	6.3%	-24.5%	4.8%	-96.1%

Hilong Holdings Ltd. (Reuters: 1623.HK, Bloomberg: 1623 HK)

Rmb in mn, year-end Dec	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (Rmb mn)	2,452	2,576	2,813	3,229	3,428
Net Profit (Rmb mn)	345	398	369	468	517
EPS (Rmb)	0.21	0.23	0.22	0.28	0.30
DPS (Rmb)	0.06	0.04	0.04	0.05	0.05
Revenue growth (%)	8.3%	5.0%	9.2%	14.8%	6.2%
EPS growth (%)	(4.4%)	13.1%	(7.3%)	26.8%	10.5%
ROCE	12.3%	10.5%	8.7%	10.1%	10.4%
ROE	14.4%	14.3%	11.9%	13.5%	13.3%
P/E (x)	7.5	6.7	7.2	5.7	5.1
P/BV (x)	0.9	0.8	0.8	0.7	0.6
EV/EBITDA (x)	5.6	6.8	5.5	4.7	4.2
Dividend Yield	4.0%	2.5%	2.3%	3.0%	3.3%

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

Company Data	
Shares O/S (mn)	1,696
Market Cap (Rmb mn)	2,646
Market Cap ($ mn)	426
Price (HK$)	1.95
Date Of Price	20 Mar 15
Free Float(%)	37.7%
3M - Avg daily vol (mn)	3.44
3M - Avg daily val (HK$ mn)	7.65
3M - Avg daily val ($ mn)	1.0
HSCEI	1,2156.40
Exchange Rate	7.76
Price Target End Date	31-Dec-15

See page 9 for analyst certification and important disclosures, including non-US analyst disclosures.

Key catalyst for the stock price:

1) Updates on current offshore contracts
2) New offshore contracts for FY15/16
3) Possible new onshore OFS contracts in 1H15
4) Interim results (Aug 2015)

Upside risks to our view:

1) Increasing product replacement cycle for drill pipes as wells become more complex
2) Higher day rates for land rigs
3) Higher-than-expected US market share
4) Better-than-expected profitability from pipe-laying barge asset

Downside risks to our view:

1) Increased competition lowering margins
2) Changes to domestic tendering process
3) US anti-dumping laws
4) Overpaying for new assets

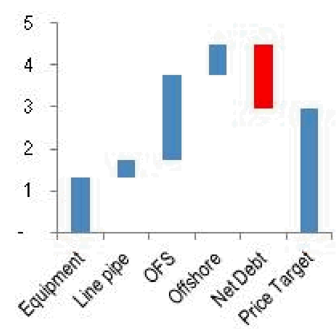
Key financial metrics	FY14	FY15E	FY16E	FY17E
Revenues (LC)	2,576	2,813	3,229	3,428
Revenue growth (%)	5%	9%	15%	6%
EBITDA (LC)	697	789	908	963
EBITDA margin (%)	27%	28%	28%	28%
Tax rate (%)	10%	16%	16%	16%
Net profit (LC)	398	369	468	517
EPS (LC)	0.234	0.217	0.276	0.305
EPS growth (%)	13%	(7%)	27%	10%
DPS (LC)	0.039	0.037	0.046	0.051
BVPS (LC)	1.853	2.065	2.294	2.547
Operating cash flow (LC mn)	261	680	453	638
Free cash flow (LC mn)	(990)	456	220	395
Interest cover (X)	9.1	7.7	9.9	12.1
Net margin (%)	15%	13%	14%	15%
Sales/assets (X)	0.45	0.43	0.48	0.48
Debt/equity (%)	78%	62%	54%	43%
Net debt/equity (%)	61%	44%	38%	29%
ROE (%)	14%	12%	13%	13%
Key model assumptions	**FY14**	**FY15E**	**FY16E**	**FY17E**
Group EBITDA Margin (%)	27%	28%	28%	28%
Capital Expenditures (LC mn)	(1,320)	(310)	(310)	(310)
Effective Tax Rate (%)	10%	16%	16%	16%

Source: Company and J.P. Morgan estimates.

Valuation and price target basis

Our Dec-2015E price target of HK$2.9 is derived from a sum-of-the-parts methodology, with each of Hilong's four business segments valued using an EV/EBITDA multiple.

Price Target Breakdown



Source: Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY17E	FY18E
2% Inc. in Tax Rate ('14/15E)	0%	0%	(2%)	(3%)
5% Inc. in OFS Revenue/Rig ('14E)	2%	2%	2%	2%
5% Inc. in drill pipe price (RMB/ton)	1%	1%	2%	1%
1% Inc. in COGS + SG&A	(2%)	(2%)	(4%)	(3%)

Source: J.P. Morgan estimates.

JPMe vs. consensus, change in estimates		
EPS	FY15E	FY16E
JPMe old	0.23	0.30
JPMe new	0.22	0.28
% chg	(5%)	(8%)
Consensus	0.33	0.38

Source: Bloomberg, J.P. Morgan estimates.

China Oil & Gas/OFS coverage comparative metrics

Company name	JPM Rating	JPM PT (LC)	CMP LC	Upside to PT (%)	Mkt Cap ($bn)	P/E(x) 15Y	P/E(x) 16Y	P/B(x) 15Y	P/B(x) 16Y	EV/EBITDA(x) 15Y	EV/EBITDA(x) 16Y	YTD Perf (%)
PETROCHINA-H	N	8.20	8.37	(2.0)	327.7	21.2	12.4	1.0	1.0	9.0	7.6	(2.7)
SINOPEC CORP-H	N	5.70	6.20	(8.1)	119.1	21.2	14.1	0.9	0.9	8.0	7.2	(0.8)
CNOOC	UW	9.00	10.54	(14.6)	60.7	16.8	9.7	1.0	0.9	4.1	3.3	1.0
SPC-H	UW	1.50	2.56	(41.4)	7.6	15.2	12.8	1.2	1.1	14.6	11.5	12.8
CBC-H	OW	4.80	2.87	67.2	1.7	7.9	8.0	0.7	0.7	3.6	3.4	4.4
COSL-H	UW	10.60	11.94	(11.2)	12.5	8.5	7.9	0.9	0.8	9.4	8.9	(11.3)
ANTON OILFIELD	UW	0.60	1.33	(54.9)	0.4	16.4	7.1	1.1	0.9	6.3	7.1	(20.4)
SPT ENERGY	N	1.40	1.25	12.0	0.2	5.9	4.3	0.7	0.6	3.2	4.2	(12.6)
HILONG HOLDING	OW	2.90	1.95	48.7	0.4	7.2	5.7	0.8	0.7	5.5	4.7	7.7
HONGHUA	UW	0.60	0.87	(31.0)	0.4	11.0	8.0	0.4	0.4	8.3	7.6	(12.1)

Source: Bloomberg, J.P. Morgan estimates

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Key points

Drillpipe volumes in line, pricing marginally declines: The oilfield equipment manufacturing and service segment reported 2H15 revenues of Rmb681mn, up 7% y/y (up 16% h/h). Hilong sold c21.4k tons of drill pipes in 2H14, in line with our estimates and product pricing was marginally down by 3%. We forecast a c45% decline in Hilong's drillpipe volumes in FY15 to c22K tons with pricing relatively flat.

Linepipe revenues down, but margins stable: Linepipe segment revenues were down c20% y/y (up 27% h/h) with gross margins of c30% in 2H14 (vs 30% in 2H13 and 36% in 1H14).

Strong top line oil services growth; consistent margins: Oilfield service revenue grew by 23% y/y (18% h/h) with gross margins at c34% (vs 35% in 1H14).

Offshore barge progressing; some offshore contribution: Hilong is progressing with its two contracts from CNOOC including one in the East China Sea (started already) and the other in the South China Sea (riser connections, mid-May); the contracts imply cRmb565mn in revenue and with the prospect of new contracts the segment revenue could begin to contribute cRmb600mn+ in the medium term.

Past the capex cycle peak; cash conversion disappointing: Capex was Rmb1.3bn in 2014, mostly the result of completing the acquisition of the company's pipelaying barge; we forecast a sharp reduction in the company's capex in FY15 to cRmb300mn. Cash conversion cycle was weaker in 2014 (c240 days vs c230 in 2013), mostly on growing inventory days (c205 days vs. c180 in 2013) and a slowing receivables conversion period (c240 days vs c 220 in 2013).

Lower dividend payout: Management recommended paying a FY14 dividend of HK$0.05/share, representing a c17% payout ratio, below the c30% payout the company has paid-out since 2011.

Increasing exposure to Russia: Hilong has acquired an additional 44% equity interest in Hilong Temerso (Russian coating business, previously held a 56% stake) from Kamelon for Rmb55m (cRmb6m gain recognized in other income) on 1 December 2014 (note: if fully consolidated would have pro-forma adj net income of Rmb387mn in FY14). Surprisingly, the company did not press release this deal unlike its Texas powder US coating deal of similar value (note: if fully consolidated would have pro-forma adj net income of Rmb399mn in FY14). The company's revenue exposure to Russia (incl Central Asia/E.Europe) was 11% in FY14 (vs 9% in FY13).

2015 outlook – unfavourable market conditions; acquisitions to provide growth: The company acknowledges with cost cutting in the oil industry, this may "impact demand for Hilong's products and services" and sees "complicated and unfavourable market conditions" in 2015. However, the company's focus is still to improve drillpipe sales to overseas markets and promote non-API drillpipe, while its two acquisitions last year, US Texas powder coating (which will strengthen cooperation with its Edmonton site in Canada) and full ownership of its Russian coating business are likely to see new development opportunities in OCTG coating services. The offshore business will soon commence operations for CNOOC's Weizhou Phase II and East China Sea project in 1H15, with "other potential opportunities" within the year. There seem to be no plans to add any further rig in its oil services segment rather a focus on improving operational efficiency of existing contracts.

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Competitors guiding to a tough year, with oil companies guiding down capex 20%+ and OCTG suppliers such as Tenaris (TS US, covered by Felipe Dos Santos, see note here) guiding to OCTG product consumptions declining by c30% y/y in FY15.

Table 1: Hilong earnings summary, h/h

Earnings	2H13	1H14	2H14	2H14E	y/y	h/h	vs JPMe
Revenue							
Oilfield equipment	639	589	681	NM	7%	16%	NM
Line pipe technology and services	192	120	152	NM	(21%)	27%	NM
Oilfield services	456	473	560	NM	23%	18%	NM
Offshore engineering services	-	-	2	NM			NM
Total Revenue	1,287	1,182	1,394	1,497	8%	18%	(6.9%)
COGS	(780)	(734)	(822)	(926)			
Other income	(198)	(210)	(275)	(264)			
Operating Income	309	238	297	307	(4%)	25%	(3.1%)
Finance Revenue / (Expense)	(33)	(49)	(28)	(47)			
Other Non-operating income (loss)	6	2	1	-			
Pre-tax profit	281	191	270	260	(4%)	41%	4.0%
Taxes	(29)	(2)	(45)	(43)			
Tax Rate, %	10%	1%	16%	17%			
Non-controlling interests	(11)	(10)	(7)	(8)			
Adjusted net income	241	179	218	209	(9%)	22%	4.5%
EPS	0.144	0.106	0.129	0.123	(11%)	22%	4.5%

Source: J.P. Morgan estimates, Company data

Table 2: Segment gross margins, h/h

	1H13	2H13	1H14	2H14
Oilfield equipment	48%	46%	41%	49%
Line pipe technology and services	24%	30%	36%	29%
Oilfield services	39%	34%	35%	34%
Offshore engineering services				71%

Source: Company reports

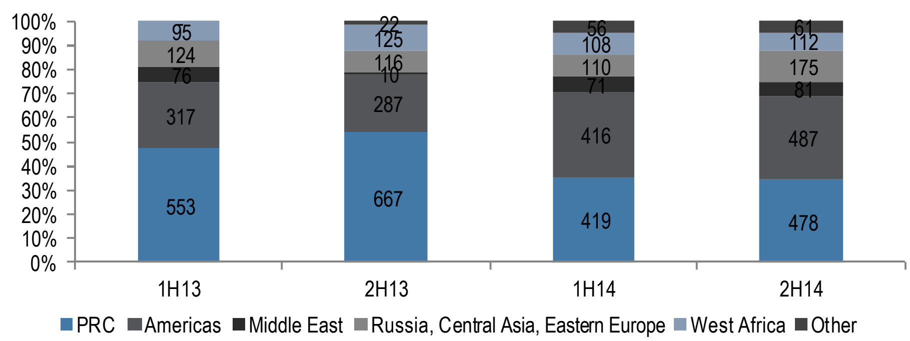
Table 3: Segment EBIT margins, h/h

	1H13	2H13	1H14	2H14
Oilfield equipment	11%	25%	19%	21%
Line pipe technology and services	10%	21%	19%	20%
Oilfield services	27%	24%	24%	23%
Offshore engineering services				Negative

Source: Company reports

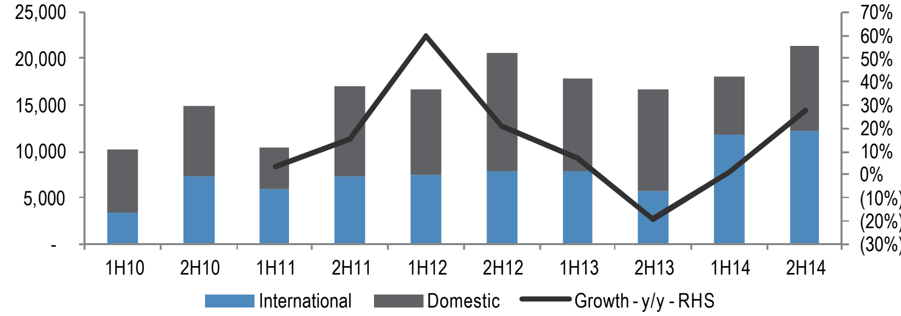
Revenue split for China has decreased from 50% in FY13 to 35% in FY14

Figure 1: Hilong sales breakdown by region



Source: Company reports

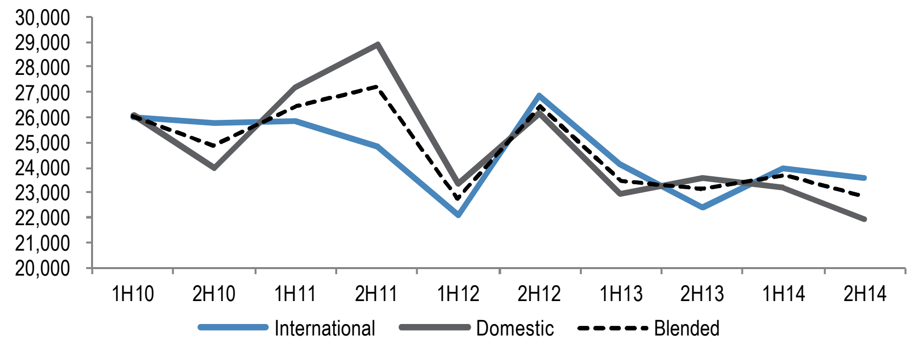
Figure 2: Hilong drillpipe sales volume (tons)



Source: Company reports

Drillpipe pricing in 2H14 was down 3% h/h

Figure 3: Hilong drillpipe average price (Rmb/ton)



Source: Company reports

FY15/17 EPS cut by c9%; new Dec-15 PT of HK$2.9

We have adjusted our FY15/17 EPS forecast by an average of 9% to reflect 2H14 results, as well as further tempering our expectations of drillpipe deliveries in FY15/16.

We update our Dec-15 PT for Hilong to HK$2.9 from HK$3.2, based on our sum-of-the-parts methodology, with each of Hilong's business segments valued using an EV/EBITDA multiple.

Table 4: Hilong EPS revisions

	New	Old	Cons	Change (%)	Vs. cons (%)
15Y	0.22	0.23	0.33	(5%)	(34%)
16Y	0.28	0.30	0.38	(8%)	(27%)
17Y	0.30	0.35	0.41	(13%)	(26%)

Source: J.P. Morgan estimates, Company data. % change is reference to New estimates.

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Investment Thesis, Valuation and Risks

Hilong Holdings Ltd. *(Overweight; Price Target: HK$2.90)*

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 firm has operations in most of China's onshore fields and is increasingly focusing offshore, as well as on international markets. 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%).
- More defensive OFS offering: We see Hilong's oilfield services segment as more insulated from slowdowns in spending with the rigs on long-term contract. We note the segment conducts only international operations and has not been affected 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 and has contracts of cRmb565mn for FY15; the segment should be a growing earnings driver.

Valuation

Our Dec-2015 price target of HK$2.90/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 (mn Rmb)	EV/EBITDA	EV	EV/Share
Oilfield equipment manufacturing and services	212	8.7	1,835	45%
Line pipe technology and services	68	8.5	577	14%
Oilfield services	347	8.1	2,797	69%
Offshore engineering services	163	6.2	1,003	25%
Total	789		6,212	153%
Net (Debt) / Cash + MI			(2,139)	(53%)
Equity value			4,073	100%
NOSH			1,696	
Fair Value (Rmb)			2.4	
Price Target (HK$)			**2.9**	
RMB/HKD Exchange Rate (Spot)			1.2	

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

Key downside 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.

Hilong Holdings Ltd.: Summary of Financials

Income Statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	2,452	2,576	2,813	3,229	3,428
% change Y/Y	8.3%	5.0%	9.2%	14.8%	6.2%
EBITDA	638	697	789	908	963
% change Y/Y	9.3%	9.4%	13.1%	15.1%	6.0%
EBIT	504	536	560	673	722
% change Y/Y	5.6%	6.3%	4.6%	20.1%	7.2%
EBIT Margin	20.6%	20.8%	19.9%	20.8%	21.1%
Net Interest	(63)	(77)	(102)	(92)	(80)
Earnings before tax	442	462	458	581	642
% change Y/Y	8.8%	4.4%	(0.7%)	26.8%	10.5%
Tax	(72)	(47)	(73)	(93)	(103)
as % of EBT	16.2%	10.1%	16.0%	16.0%	16.0%
Net income (reported)	345	398	369	468	517
% change Y/Y	(0.1%)	15.4%	(7.3%)	26.8%	10.5%
Shares outstanding	1,663	1,696	1,696	1,696	1,696
EPS (reported)	0.21	0.23	0.22	0.27	0.30
% change Y/Y	(5.2%)	13.3%	(7.3%)	26.8%	10.5%

Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
EBIT	504	536	560	673	722
Depr. & amortization	136	164	229	235	241
Change in working capital	(300)	(167)	83	(250)	(119)
Taxes	150	(47)	(73)	(93)	(103)
Cash flow from operations	174	261	680	453	638
Capex	(459)	(1,320)	(310)	(310)	(310)
Disposal/(purchase)	-	-	-	-	-
Net Interest	(63)	(77)	(102)	(92)	(80)
Other	(42)	0	0	0	0
Free cash flow	(232)	(990)	456	220	395
Equity raised/(repaid)	0	(57)	52	0	0
Debt raised/(repaid)	431	0	(308)	(64)	(242)
Other	(10)	1,337	0	0	0
Dividends paid	(99)	(67)	(62)	(79)	(87)
Beginning cash	404	391	548	600	600
Ending cash	391	548	600	600	600
DPS	0.06	0.04	0.04	0.05	0.05

Balance sheet					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	391	548	600	600	600
Accounts receivable	1,534	1,879	1,696	1,946	2,066
Inventories	738	841	793	902	958
Others	131	84	84	84	84
Current assets	2,794	3,352	3,173	3,532	3,708
LT investments	-	-	-	-	-
Net fixed assets	1,614	2,856	2,938	3,013	3,082
Total Assets	4,807	6,627	6,530	6,964	7,209
Liabilities					
Short-term loans	654	833	525	460	219
Payables	661	942	793	902	958
Others	8	8	9	10	11
Total current liabilities	1,324	1,783	1,327	1,373	1,188
Long-term debt	507	1,630	1,630	1,630	1,630
Other liabilities	103	70	70	70	70
Total Liabilities	1,934	3,484	3,028	3,073	2,888
Shareholder's equity	2,655	2,918	3,277	3,666	4,096
BVPS (Rmb)	1.73	1.85	2.06	2.29	2.55

Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
EBITDA margin	26.0%	27.1%	28.0%	28.1%	28.1%
EBIT margin	20.6%	20.8%	19.9%	20.8%	21.1%
Net margin	14.1%	15.4%	13.1%	14.5%	15.1%
Sales per share growth	3.7%	3.0%	9.2%	14.8%	6.2%
Sales growth	8.3%	5.0%	9.2%	14.8%	6.2%
Net profit growth	(0.1%)	15.4%	(7.3%)	26.8%	10.5%
EPS growth	(5.2%)	13.3%	(7.3%)	26.8%	10.5%
Interest coverage (x)	10.2	9.1	7.7	9.9	12.1
Net debt to equity	26.8%	60.9%	44.4%	38.3%	28.9%
Sales/assets	0.6	0.5	0.4	0.5	0.5
Assets/equity	1.9	2.1	2.1	1.9	1.8
ROE	14.4%	14.3%	11.9%	13.5%	13.3%
ROCE	12.3%	10.5%	8.7%	10.1%	10.4%

Source: Company reports and J.P. Morgan estimates.

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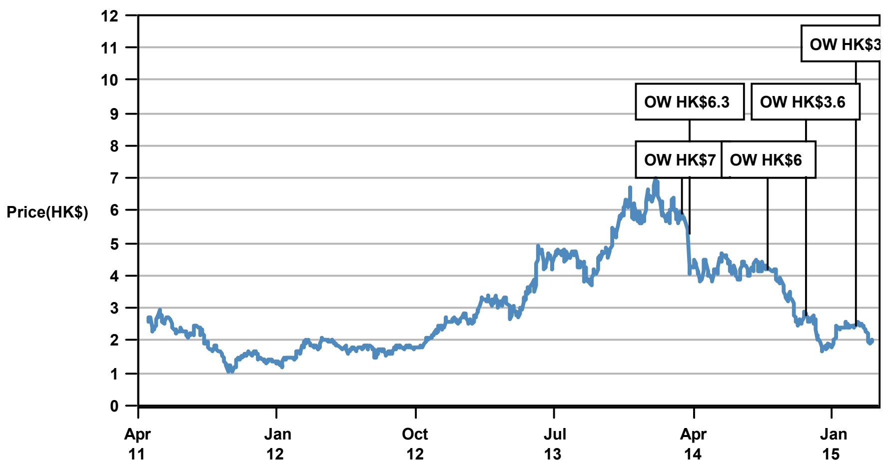
Hilong Holdings Ltd. (1623.HK, 1623 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
09-Mar-14	OW	5.90	7.00
24-Mar-14	OW	5.27	6.30
25-Aug-14	OW	4.20	6.00
09-Nov-14	OW	2.78	3.60
15-Feb-15	OW	2.48	3.20

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 09, 2014.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.
J.P. Morgan ratings or designations: OW = Overweight, N= Neutral, UW = Underweight, NR = Not Rated

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*Percentage of investment banking clients in each rating category.
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