

Hilong Holding [1623.HK]

More unfavorable factors across segments to dampen earnings this year; Maintain HOLD

We maintain our cautious stance on Hilong as we continue to see uncertainties this year due to: (1) a decline in overseas drill pipe sales; (2) pressure on drill rigs day rates; (3) less OCTG materials trading revenue in oilfield services segment. In view of the weakness in the major segments and potential margin pressure, we trimmed our 2015E/2016E earnings forecasts by 17%/23% and lowered our TP from HK\$2.52 to HK\$2.10 (based on unchanged multiple of 8.5x 2015E PER). Maintain **HOLD**.

- **Drill pipe sales to turn weak this year.** Management reveals during the analyst meeting that drill pipe sales volume in overseas will drop this year, despite domestic sales will likely to remain stable. We believe the weakness in sales volume will imply pressure on both ASP and margin this year.
- **Pressure on drill rigs day rates.** Utilization rate of Hilong's rig fleet is currently ~85%. We are not surprised by the management comments that there could be pressure on the day rates for some existing contracts, given the low oil price environment. We believe this is an early sign of day rate risk and reaffirm our cautious stance on this segment.
- **Lower OCTG trading revenue.** OCTG trading revenue was ~US\$50m in 2014, accounting for ~30% of the oilfield services segment revenue which was also a key growth driver of the oilfield services segment revenue. However, Hilong expects the trading revenue this year to drop 40% to US\$30m, suggesting huge downside pressure to the segment revenue. We estimate the significant decline in the trading revenue will drive the oilfield services revenue down by 12% YoY this year.
- **Line pipe segment to see improvement this year.** Management targets to deliver growth this year, driven by new business lines like CRA (corrosion resistant alloy), CWC (concrete weighted coating), as well as pipeline inspection services. Despite the growth, we estimate the segment will contribute only ~15% of the total EBIT this year, which will not be enough to drive a recovery.
- **Pipe laying vessel (Hilong 106) to drive revenue but may drag margin.** To recap, Hilong signed two contracts with CNOOC for a total value of US\$90m, a key revenue driver this year. That said, we expect gross margin to be between 20-30%, lower than that of the existing business lines.
- **Receivables days peaked in 2014.** Management expects the receivable days to be improved this year from 192 days as of end-2014, and is confident that the days to return to the level in 2013.
- **Upside risks:** (1) Oil price recovery; (2) Drilling demand recovery; (3) More new order intakes. **Downside risks:** (1) Further capex cut by oil companies; (2) Potential suspension on drill rigs operation by customers; (3) Margin squeeze; (4) Rising receivables.

Oilfield Services Sector

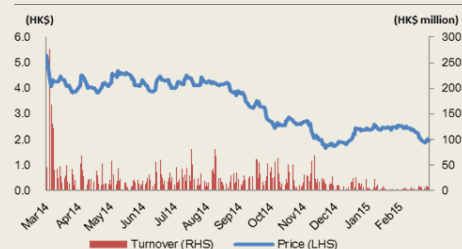
HOLD

(Unchanged)

Close: HK\$1.95 (Mar 23, 2015)

Target Price: HK\$2.10 (+8%)

Share Price Performance



Market Cap	US\$424m
Shares Outstanding	1,695m
Auditor	PWC
Free Float	34%
52W range	HK\$1.61-5.12
3M average daily T/O	US\$0.8m
Major Shareholding	ZHANG Jun (Chairman and CEO)
	(60%)

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Earnings Projections

(RMB m)	2013	2014	2015E	2016E
Income Statement (YE Dec)				
Revenue	2,452	2,576	3,096	3,284
Oilfield equipment manufacturing & services	1,214	1,270	1,180	1,300
Line pipe technology and services	365	272	453	482
Oilfield services	873	1,032	913	890
Offshore engineering	0	2	551	612
COGS	(1,464)	(1,555)	(2,026)	(2,153)
Gross profit	988	1,021	1,070	1,131
Oilfield equipment manufacturing & services	570	575	496	540
Line pipe technology and services	99	88	140	149
Oilfield services	318	357	297	289
Offshore engineering	0	1	138	153
Operating cost	(484)	(482)	(524)	(559)
EBIT	504	536	547	572
Oilfield equipment manufacturing & services	225	254	177	189
Line pipe technology and services	58	53	81	87
Oilfield services	221	239	194	189
Offshore engineering	0	(10)	94	107
D&A	136	164	246	260
EBITDA	640	700	793	832
Finance income	8	13	2	3
Finance costs	(71)	(90)	(140)	(142)
Profit/(loss) of associates/JCE	1	3	1	1
Pretax profit	442	462	410	434
Income tax expenses	(72)	(47)	(61)	(65)
After tax profit	371	415	348	369
Minority interests	(26)	(17)	(15)	(15)
Net profit	345	398	333	353
Recurring net profit	425	375	333	353

EPS (RMB)				
Reported	0.207	0.234	0.197	0.208
Recurring	0.256	0.221	0.197	0.208
DPS (RMB)				
	0.062	0.039	0.029	0.031

(RMB m)	2013	2014	2015E	2016E
Balance Sheet (as of end-Dec)				
Non current assets				
Property, plant and equipment	1,614	2,856	2,761	2,652
Lease prepayments	95	93	93	93
Intangible assets	73	159	161	162
Investment in associates/JCE	71	57	57	57
Deferred income tax assets	99	109	109	109
Other long-term assets	61	1	1	1
Total non current assets	2,013	3,275	3,182	3,075
Current assets				
Inventories	738	841	1,013	1,015
Trade receivables	1,171	1,535	1,519	1,720
Prepayment, bills and other receivables	364	344	461	393
Restricted cash	130	84	84	84
Cash	391	548	659	834
Others	1	0	0	0
Total current assets	2,794	3,352	3,737	4,045
Total assets	4,807	6,627	6,918	7,120
Non current liabilities				
Long term borrowings	507	1,630	1,630	1,630
Deferred income tax liabilities	77	44	44	44
Derivative financials instruments	4	2	2	2
Deferred revenue	23	24	24	24
Total non current liabilities	610	1,700	1,700	1,700
Current liabilities				
Short term borrowings	654	833	863	893
Trade payables	340	560	494	343
Derivative financials instruments	0	1	1	1
Other payables	322	382	428	433
Current income tax liabilities	8	7	7	7
Deferred revenue	0	0	0	0
Total current liabilities	1,324	1,783	1,794	1,677
Equity				
Share capital	142	142	142	142
Reserves	2,513	2,776	3,043	3,346
	2,655	2,918	3,185	3,488
MI	218	225	239	255
Total equity	2,874	3,143	3,424	3,743
Total equity and liabilities	4,807	6,627	6,918	7,120
BVPS (RMB)				
	1.57	1.72	1.88	2.06

Sources: Company, CGIHK Research estimates

(RMB m)	2013	2014E	2015E	2016E
Cash Flow Statement (YE Dec)				
Pretax profit	442	462	410	434
Depreciation	134	162	245	259
Amortization	1	1	1	1
Share of results of Associates/JCE	(1)	(3)	(1)	(1)
Interest expenses	65	90	140	142
Change in working capital	(300)	(166)	(293)	(281)
Interest paid	(90)	(90)	(140)	(142)
Income tax paid	(150)	(47)	(61)	(65)
Others	73	(147)	0	0
Operating cash flow	174	261	300	346
Purchase/(disposal) of PP&E	(456)	(1,404)	(150)	(150)
Purchase of intangible assets	(0)	(87)	(3)	(3)
Acquisition of subsidiaries	(18)	0	0	0
Investment in associates/JCE	(25)	0	0	0
Dividend received from associates/JCE	2	3	1	1
Others	(5)	168	0	0
Investing cash flow	(501)	(1,320)	(152)	(152)
Proceed from/(repayment of) borrowings	431	1,302	30	30
Proceed from equity	0	0	0	0
Proceed from CB	0	0	0	0
Dividend paid	(99)	(103)	(67)	(50)
Others	(10)	14	0	0
Financing cash flow	323	1,213	(37)	(20)
Net change in cash	(4)	154	111	174

	2013	2014	2015E	2016E
Valuation				
PER (recurring earnings) (x)	6.1	7.0	7.8	7.4
Dividend yield	4.0%	2.6%	1.9%	2.0%
PBR (x)	1.0	0.9	0.8	0.7
EV/EBITDA (x)	6.3	5.8	5.1	4.8
Growth rate				
Revenue	8%	5%	20%	6%
EBIT	6%	6%	2%	5%
EBITDA	10%	9%	13%	5%
Recurring net profit	16%	-12%	-11%	6%
Recurring EPS	11%	-14%	-11%	6%
Operating ratios				
Gross margin	40%	40%	35%	34%
EBIT margin	21%	21%	18%	17%
EBITDA margin	26%	27%	26%	25%
Recurring net margin	17%	15%	11%	11%
Asset turnover	0.55	0.45	0.46	0.47
Adjusted ROE	18%	13%	11%	11%
Adjusted ROA	10%	7%	5%	5%
Interest coverage	10.2	9.1	5.7	6.0
Net debt/equity	22%	58%	51%	43%
Current ratio	2.1	1.9	2.1	2.4
Quick ratio	1.7	1.5	1.7	1.9
Days inventories	165	185	167	172
Days receivables	165	192	180	180
Days payables	76	106	95	71

Figure 1: Hilong results highlights

Results highlights (RMB m)	1H13	1H14	Chg (YoY)	2H13	2H14	Chg (YoY)	2013	2014	Chg (YoY)	Comments
Oilfield equipment manufacturing and services										
Revenue	575	589	2%	639	681	7%	1,214	1,270	5%	Drill pipe revenue +4.6% YoY.
Cost of sales	(300)	(350)	17%	(344)	(345)	0%	(644)	(696)	8%	OCTG coating services revenue +4.8% YoY.
Gross profit	276	239	-13%	295	336	14%	570	575	1%	
Gross margin	47.9%	40.6%		46.1%	49.3%		47.0%	45.3%		Gross margin improved in 2H14.
Operating expenses	(211)	(130)	-38%	(134)	(191)	42%	(345)	(321)	-7%	
Opex ratio	36.7%	22.0%		21.0%	28.1%		28.4%	25.3%		
EBIT	65	109	69%	160	144	-10%	225	254	13%	
EBIT margin	11.2%	18.6%		25.1%	21.2%		18.5%	20.0%		
Line pipe technology and services										
Revenue	173	120	-31%	192	152	-21%	365	272	-26%	Revenue decline was due to weakness line pipe
Cost of sales	(131)	(77)	-42%	(135)	(107)	-20%	(266)	(184)	-31%	coating segment despite strong growth of CRA lined
Gross profit	42	43	4%	58	44	-23%	99	88	-12%	pipe sales (accounted for 27% of the segment
Gross margin	24.1%	36.1%		29.9%	29.2%		27.1%	32.3%		revenue).
Operating expenses	(24)	(21)	-14%	(17)	(14)	-18%	(41)	(35)	-15%	
Opex ratio	14.1%	17.6%		8.7%	9.0%		11.3%	12.8%		
EBIT	17	22	29%	41	31	-25%	58	53	-9%	
EBIT margin	10.0%	18.5%		21.2%	20.2%		15.9%	19.5%		
Oilfield services										
Revenue	417	473	13%	456	560	23%	873	1,032	18%	
Cost of sales	(253)	(307)	21%	(301)	(368)	22%	(554)	(675)	22%	
Gross profit	164	166	1%	155	191	24%	318	357	12%	
Gross margin	39.3%	35.0%		33.9%	34.2%		36.5%	34.6%		
Operating expenses	(50)	(53)	5%	(47)	(62)	32%	(97)	(115)	18%	
Opex ratio	12.0%	11.2%		10.4%	11.2%		11.2%	11.2%		
EBIT	114	113	-1%	107	126	17%	221	239	8%	
EBIT margin	27.3%	23.9%		23.6%	22.5%		25.3%	23.1%		
Offshore engineering services										
Revenue	0	0	n/a	0	2	n/a	0	2	n/a	Pipe laying vessel will start contribution in 2015.
Cost of sales	0	0	n/a	0	(1)	n/a	0	(1)	n/a	
Gross profit	0	0	n/a	0	1	n/a	0	1	n/a	
Gross margin	0.0%	n/a		0.0%	70.6%		0.0%	70.6%		
Operating expenses	0	(6)	n/a	0	(5)	n/a	0	(11)	n/a	
Opex ratio	0.0%	n/a		0.0%	280.0%		0.0%	635.8%		
EBIT	0	(6)	n/a	0	(4)	n/a	0	(10)	n/a	
EBIT margin	0.0%	n/a		0.0%	-209.5%		0.0%	-565.3%		
Total										
Revenue	1,165	1,182	1%	1,287	1,394	8%	2,452	2,576	5%	
Cost of sales	(684)	(734)	7%	(780)	(822)	5%	(1,464)	(1,555)	6%	
Gross profit	481	448	-7%	507	573	13%	988	1,021	3%	Gross margin rebounded in 2H14.
Gross margin	41.3%	37.9%		39.4%	41.1%		40.3%	39.6%		
Operating expenses	(285)	(210)	-26%	(199)	(272)	37%	(484)	(482)		
EBIT	196	238	22%	309	297	-4%	504	536	6%	
D&A	63	83	32%	73	82	11%	136	164	21%	
EBITDA	259	321	24%	382	379	-1%	640	700	9%	
Finance income	5	1	n/a	4	12	218%	8	13	54%	
Finance costs	(34)	(51)	49%	(37)	(39)	6%	(71)	(90)	26%	RMB24m of interest payment was capitalized in 2014.
Profit/(loss) of associates/JCE	(5)	2	n/a	6	1	-89%	1	3	287%	
Pretax profit	161	191	19%	281	270	-4%	442	462	4%	
Income tax expenses	(43)	(2)	-95%	(29)	(45)	56%	(72)	(47)	-35%	Income tax decline was due to one-off tax refund of
After tax profit	118	189	60%	252	226	-11%	371	415	12%	RMB38m in 1H14.
Minority interests	(15)	(10)	-32%	(11)	(7)	-33%	(26)	(17)	-32%	
Net profit	103	179	73%	241	218	-9%	345	398	15%	
Recurring net profit	177	141	-21%	248	234	-6%	425	375	-12%	Recurring net profit is adjusted for the one-off tax effect.

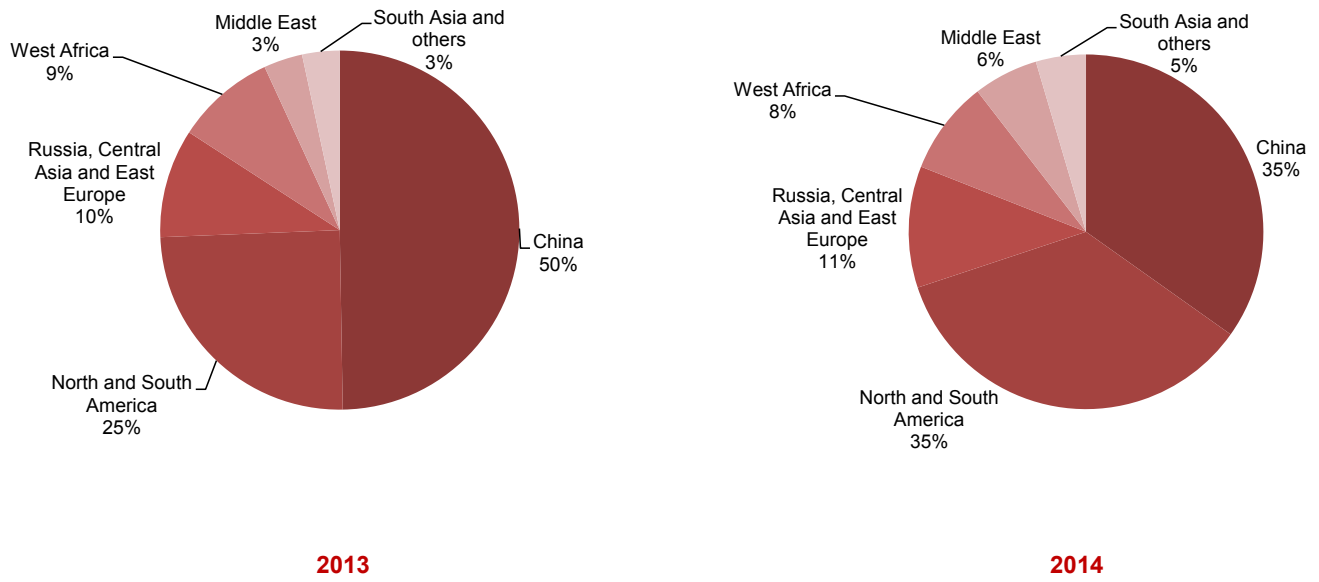
Sources: Company, CGIHK Research estimates

Figure 2: Hilong drill pipe segment highlights

Revenue (RMB m)	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
Drill pipes and related products										
Drill pipes										
Breakdown by region										
China										
Sales volume (t)	15,839	21,900	11,314	14,469	14,549	22,194	20,997	15,397	15,000	16,000
Change YoY	-	38.3%	-48.3%	27.9%	0.6%	52.5%	-5.4%	-26.7%	-2.6%	6.7%
ASP (RMB/t)	30,941	25,493	26,357	24,961	28,357	24,954	23,280	22,427	20,500	21,000
Change YoY	-	-17.6%	3.4%	-5.3%	13.6%	-12.0%	-6.7%	-3.7%	-8.6%	2.4%
Revenue (RMB m)	490	558	298	361	413	554	489	345	308	336
Change YoY	-	13.9%	-46.6%	21.1%	14.2%	34.2%	-11.7%	-29.4%	-11.0%	9.3%
Overseas										
Sales volume (t)	4,419	17,120	3,961	10,550	13,059	15,213	13,665	24,101	22,000	23,000
Change YoY	-	287.4%	-76.9%	166.3%	23.8%	16.5%	-10.2%	76.4%	-8.7%	4.5%
ASP (RMB/t)	35,931	37,830	29,395	25,842	25,267	24,541	23,401	23,745	22,500	23,000
Change YoY	-	5.3%	-22.3%	-12.1%	-2.2%	-2.9%	-4.6%	1.5%	-5.2%	2.2%
Revenue (RMB m)	159	648	116	273	330	373	320	572	495	529
Change YoY	-	307.9%	-82.0%	134.2%	21.0%	13.1%	-14.3%	79.0%	-13.5%	6.9%
Drill pipe total										
Sales volume (t)	20,258	39,020	15,275	25,019	27,608	37,407	34,662	39,498	37,000	39,000
Change YoY	-	92.6%	-60.9%	63.8%	10.3%	35.5%	-7.3%	14.0%	-6.3%	5.4%
ASP (RMB/t)	32,030	30,906	27,145	25,333	26,895	24,786	23,328	23,231	21,689	22,179
Change YoY	-	-3.5%	-12.2%	-6.7%	6.2%	-7.8%	-5.9%	-0.4%	-6.6%	2.3%
Drill pipe revenue (RMB m)	649	1,206	415	634	743	927	809	918	803	865
Change YoY	-	85.9%	-65.6%	52.9%	17.2%	24.9%	-12.8%	13.5%	-12.5%	7.8%
Drill pipe components	0	0	0	21	94	27	83	30	32	34
Hardbanding	0	14	14	25	16	12	13	16	18	18
Equipment	13	18	34	1	11	16	1	0	5	8
Others	8	24	56	32	41	29	45	30	35	37
Total	670	1,261	519	713	904	1,011	951	994	893	962
Change YoY	-	88.2%	-58.9%	37.5%	26.7%	11.9%	-6.0%	4.6%	-10.2%	7.8%

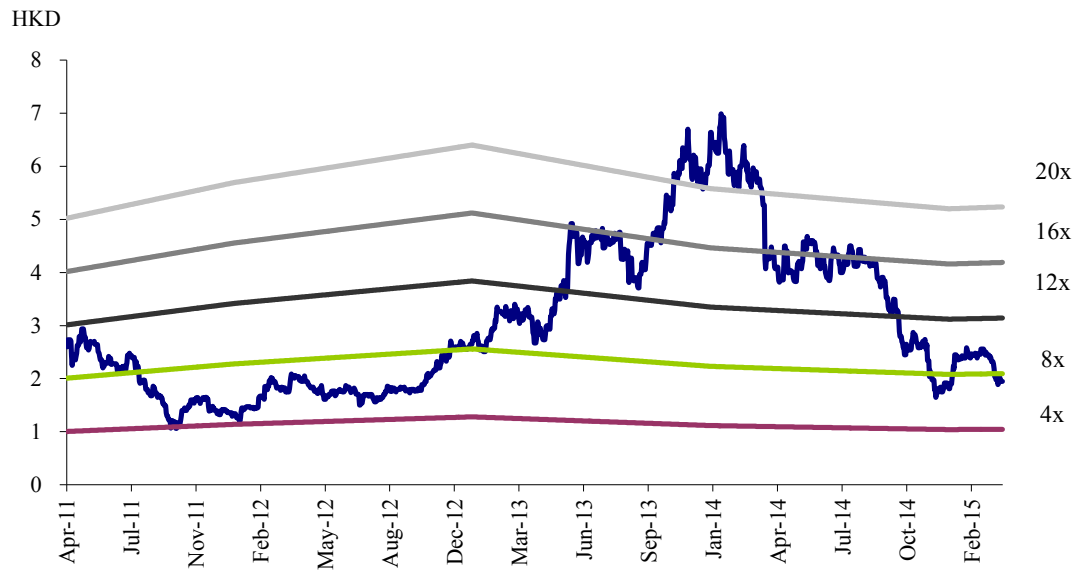
Sources: Company, CGIHK Research estimates

Figure 3: Hilong revenue breakdown by regions



Sources: Company, CGIHK Research

Figure 4: Hilong PER band



Sources: Bloomberg, CGHK Research estimates

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BUY : share price will increase by >20% within 12 months in absolute terms

SELL : share price will decrease by >20% within 12 months in absolute terms

HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

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