

**Nat Resources & Energy**  
**Metals & Mining**  
 Equity – China

## Hold

Target price (HKD)	1.62		
Share price (HKD)	1.50		
Upside/Downside (%)	8		
Performance	1M	3M	12M
Absolute (%)	0.0	-10.7	-36.2
Relative <sup>A</sup> (%)	2.2	-13.8	-47.5
Index <sup>A</sup>	HSCEI		
RIC	0639.HK		
Bloomberg	639 HK		
Market cap (USDm)	1,025		
Market cap (HKDm)	7,953		
Enterprise value (HKDm)	2520		
Free float (%)	70		

**27 March 2015**

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# Shougang Fushan (639 HK)

Hold: Big loss in 2014, but well flagged

- **Fushan reported a loss of HKD425m in 2014 due to goodwill impairment, in line with the profit warning on Mar 16**
- **Earnings are bottoming but valuation unattractive given subdued outlook for coking coal prices**
- **We establish a Hold rating with a fair value TP of HKD1.62 based on a blend of PE and DCF**

**Big loss in 2014...** Fushan reported net loss of HKD425m in 2014, down substantially from a gain of RMB1.1bn in 2013, in line with the profit warning announced on Mar 16. Other than weak coking coal prices, the loss was caused by non-recurring items including a goodwill impairment loss of HKD824m (loss of HKD300m in 1H14 and we forecast HKD500m for FY14), a forex loss of RMB96m due to RMB depreciation, and a donation of HKD240m (final time on agreement with the local government). Despite the loss, Fushan declared a final dividend of HKD2.7cents (interim dividend HKD1 cent).

**...but gross margins were not bad.** Although average selling prices of raw and clean coal both declined by 22% y-o-y, Fushan managed to partially offset the negative impact through a better sales mix and lower production costs. The proportion of clean coal sales rose from 56% in 2013 to 75% in 2014. Raw coal production costs and processing cost for clean coal fell by 5% and 9% y-o-y respectively. As a result, gross margin fell by just 11 percentage points y-o-y to 40% in 2014. Fushan only mined 5.7m tonnes of raw coal in 2014, the lowest volume since 2009, presumably due to resources reservation in a poor coking coal market.

**Earnings bottoming yet outlook remains poor.** We expect Fushan to turn profitable again in 2015 with estimated net profit of RMB498m as the significant goodwill impairment loss and donation expenses are unlikely to recur this year. However, given Fushan's lack of organic volume growth and a subdued outlook for coking coal prices, we believe Fushan's near-term earnings outlook remains challenging.

**We establish a Hold rating with a fair value TP of HKD1.62.** Our target price is based on 50:50 blend of PE and life-of-mine DCF valuation. We make no changes to our earnings estimates. Although earnings are bottoming, we think the stock is fairly valued given the subdued outlook for coking coal prices. Upside risks include stronger-than-expected Chinese coking coal prices, lower-than-expected production costs and successful future acquisitions; Key downside risks are weaker-than-expected coal prices and higher-than-expected production costs.

## Financials & valuation

### Financial statements

Year to	12/2013a	12/2014e	12/2015e	12/2016e
<b>Profit &amp; loss summary (HKDm)</b>				
Revenue	4,268	3,255	3,192	3,384
EBITDA	2,011	983	1,117	1,297
Depreciation & amortisation	-566	-539	-519	-541
Operating profit/EBIT	1,445	444	598	755
Net interest	105	165	116	128
PBT	1,830	-139	814	983
HSBC PBT	1,830	-139	814	983
Taxation	-531	-222	-228	-246
Net profit	1,115	-425	498	627
HSBC net profit	1,115	-425	498	627

### Cash flow summary (HKDm)

Cash flow from operations	2,065	-122	1,313	1,196
Capex	-283	-450	-450	-450
Cash flow from investment	-260	1,292	-1,740	-425
Dividends	-673	-196	-224	-282
Change in net debt	-1,432	-207	114	-489
FCF equity	1,814	511	845	718

### Balance sheet summary (HKDm)

Intangible fixed assets	12,729	11,421	11,818	11,533
Tangible fixed assets	3,610	3,412	4,022	4,216
Current assets	8,821	8,422	8,028	8,543
Cash & others	5,807	5,507	5,649	6,138
Total assets	26,871	24,000	25,251	25,675
Operating liabilities	2,480	2,301	2,150	2,165
Gross debt	580	74	330	330
Net debt	-5,227	-5,433	-5,319	-5,808
Shareholders funds	19,927	17,927	19,255	19,639
Invested capital	16,873	15,447	16,068	15,988

### Ratio, growth and per share analysis

Year to	12/2013a	12/2014e	12/2015e	12/2016e
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#### Y-o-y % change

Revenue	-24.5	-23.7	-1.9	6.0
EBITDA	-36.8	-51.1	13.6	16.1
Operating profit	-45.5	-69.3	34.7	26.4
PBT	-38.4	-107.6		20.8
HSBC EPS	-37.8	-138.1		25.9

#### Ratios (%)

Revenue/IC (x)	0.2	0.2	0.2	0.2
ROIC	6.0	7.1	2.7	3.5
ROE	5.7	-2.2	2.7	3.2
ROA	4.9	-1.3	2.4	2.9
EBITDA margin	47.1	30.2	35.0	38.3
Operating profit margin	33.9	13.6	18.7	22.3
EBITDA/net interest (x)				
Net debt/equity	-24.1	-27.8	-25.6	-27.4
Net debt/EBITDA (x)	-2.6	-5.5	-4.8	-4.5
CF from operations/net debt				

#### Per share data (HKD)

EPS reported (fully diluted)	0.21	-0.08	0.09	0.12
HSBC EPS (fully diluted)	0.21	-0.08	0.09	0.12
DPS	0.11	0.04	0.04	0.05
Book value	3.76	3.38	3.63	3.70

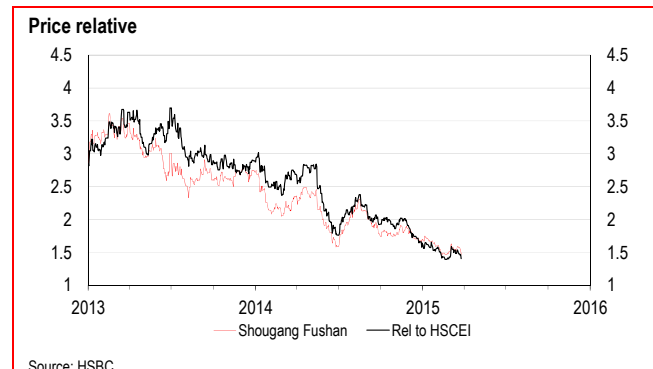
### Key forecast drivers

Year to	12/2013a	12/2014e	12/2015e	12/2016e
Raw coal sales volume (kt)	1,960	1,010	1,200	1,200
Clean coal sales volume (kt)	2,530	3,000	3,000	3,000
Raw coal ASP (RMB/t)	540	422	392	421
Clean coal ASP (RMB/t)	920	721	688	738
Raw coal unit cost (RMB/t)	260	248	261	266
Clean coal unit cost (RMB/t)	459	433	484	494

### Valuation data

Year to	12/2013a	12/2014e	12/2015e	12/2016e
EV/sales	0.6	0.8	0.8	0.6
EV/EBITDA	1.4	2.6	2.4	1.7
EV/IC	0.2	0.2	0.2	0.1
PE*	7.1		16.0	12.7
P/Book value	0.4	0.4	0.4	0.4
FCF yield (%)	22.8	6.4	10.6	9.0
Dividend yield (%)	7.0	2.5	2.8	3.5

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 26 Mar 2015

#### 2014 results vs. our previous estimates

HKD m	2013	2014	YoY	2014e	vs estimate	1H14	2H14	HoH
Revenue	4,268	3,255	-24%	3,282	-1%	1,702	1,552	-9%
Cost of sales	2,095	1,951	-7%	2,155	-9%	955	996	4%
Gross profit	2,173	1,304	-40%	1,127	16%	748	556	-26%
Gross margin	51%	40%		34%		44%	36%	
Selling expenses	142	301	112%	197	53%	103	198	93%
Admin & other expenses	586	559	-5%	580	-4%	375	185	-51%
Operating profit	1,445	444	-69%	350	27%	270	173	-36%
Operating margin	34%	14%		11%		16%	11%	
Interest expenses	(24)	(11)	-54%	(18)	-36%	(8)	(3)	-65%
Interest income	130	176	36%	134	31%	99	77	-22%
Others	280	(748)	-367%	(520)	44%	(391)	(356)	-9%
Income before tax	1,830	(139)	-108%	(53)	160%	(30)	(109)	260%
Tax charges	(531)	(222)	-58%	15	-1580%	(131)	(91)	-31%
Effective tax rate	29%	-159%		28%		-433%	-83%	
Minority interest	184	64	-65%	(6)	-1214%	30	34	11%
Net income	1,115	(425)	-138%	(33)	1199%	(192)	(234)	22%
Net margin	26%	-13%		-1%		-11%	-15%	

Source: Company data, HSBC estimates

#### Key operating data

	2013	2014	YoY	2014e	vs estimate	1H14	2H14	HoH
<b>Production volume, tonnes 000s</b>								
Raw coal	6,130	5,680	-7%	6,100	-7%	2,960	2,720	-8%
Clean coal	2,670	3,010	13%	2,940	2%	1,490	1,520	2%
<b>Sales volume, tonnes 000s</b>								
Raw coal	1,960	1,010	-48%	1,200	-16%	560	450	-20%
Clean coal	2,530	3,000	19%	2,940	2%	1,410	1,590	13%
<b>Selling prices, Rmb/t</b>								
Raw coal	540	422	-22%	408	4%	469	364	-22%
Clean coal	920	721	-22%	715	1%	779	670	-14%

Source: Company data, HSBC estimates

## Valuation and risks

Our fair value target price of HKD1.62 is based on a 50:50 blend between a PE-based value of HKD1.22, based on 13.0x 2015e PE, and a life-of-mine DCF valuation of HKD2.02. Our PE multiple is based on Fushan's average PE over the past two years. Our DCF valuation is based on: (1) a cost of capital of 10.7%; (2) adjusted beta of 1.18 measured against the HSCEI index; and (3) the company remaining in a net cash position in the long run. We establish a Hold rating on the stock (vs Neutral under our old ratings model).

**Upside risks:** stronger-than-expected Chinese coking coal prices, lower-than-expected production costs and successful future acquisitions; **Downside risks:** weaker-than-expected coking coal prices and higher-than-expected production costs.

# Disclosure appendix

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The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

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Upside/Downside is the percentage difference between the target price and the share price.

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For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands were classified as Neutral.

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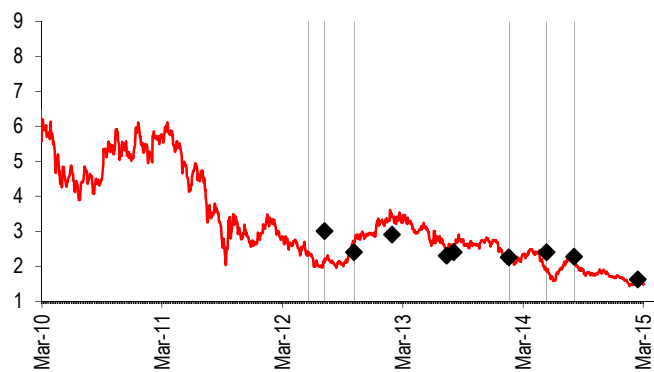
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For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

## Share price and rating changes for long-term investment opportunities

Shougang Fushan (0639.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight (V)	N/A	11 June 2012
N/A	Overweight (V)	31 July 2012
Overweight (V)	Underweight (V)	28 October 2012
Underweight (V)	Neutral (V)	11 February 2014
Neutral (V)	Overweight (V)	05 June 2014
Overweight (V)	Neutral	28 August 2014
Target Price	Value	Date
Price 1	N/A	11 June 2012
Price 2	3.00	31 July 2012
Price 3	2.40	28 October 2012
Price 4	2.90	21 February 2013
Price 5	2.30	06 August 2013
Price 6	2.40	28 August 2013
Price 7	2.25	11 February 2014
Price 8	2.40	05 June 2014
Price 9	2.27	28 August 2014
Price 10	1.62	09 March 2015

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
SHOUGANG FUSHAN	0639.HK	1.50	26-Mar-2015	6, 7

Source: HSBC

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