

Honghua Group (196 HK)

Underperform (downgraded)

Target price: HK\$0.83



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Uncertain outlook; downgrade to Underperform

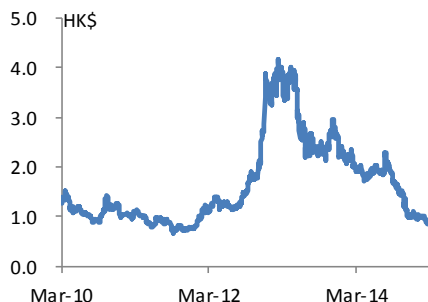
Results much worse than expected 2014 net profit slumped 83% YoY to Rmb91.8m, 53% below consensus, due to: 1) YoY decline in 2H14 topline; 2) deeper operating loss from its offshore segment and onshore oil servicing segment; 3) higher-than-expected admin expenses and financial costs. Honghua also announced that its financial controller, Paul Chung, has resigned and will be replaced by Yuan Hai, CFO of one of Honghua's subsidiaries.

Unclear guidance for 2015 Unlike previous years, management did not give clear guidance for its 2015 revenue growth target during the post-results presentation. However, in term of EBIT, management hopes to break even in both its onshore oil services segment and offshore segment in 2015, and expects to maintain low capex of around Rmb300m, mainly used in its offshore segment.

We slash our 2015/16 earnings forecasts, again We cut our 2015/16 net profit forecasts by 73%/81%, given 1) lower land rig sales volume on the low crude oil price; 2) weaker-than-expected recovery in the oil servicing segment, in which we expect Honghua to still record a gross loss in 2015; 3) declining gross margin in its parts and components segment due to a further increase in trading revenue. We expect net gearing to remain above 60% in 2015/16, mainly due to the US\$200m note issued last year.

TP cut, downgrade to Underperform We believe these results will continue to put pressure on Honghua's share performance in the near term. Despite the company trading at 0.48x 2015E P/B, which is close to its five-year low of 0.42x forward P/B, we expect Honghua to trade at a lower multiple given its low earnings visibility and capex-based revenue model. We reset our target price at HK\$0.83, based on 0.45x 2015E P/B. We use P/B as a valuation benchmark due to the high volatility in earnings. We downgrade the stock to Underperform.

Stock performance



Source: Bloomberg

Key data

Mar 27 close (HK\$)	0.89
Shares in issue (m)	3,241
Major shareholder	Zhang Mi (48.2%)
Market cap (HK\$ bn)	2.9
3M avg. vol. (m)	12.1
52W high/low (HK\$)	2.42 / 0.83

Source: Bloomberg

Stock valuation

	Turnover (Rmb m)	Net profit (Rmb m)	EPS (Rmb)	EPS YoY (%)	P/E	BPS (Rmb)	P/B	ROE (%)
2013	8,047	538	0.166	1.3	4.3	1.47	0.48	11.3
2014	7,813	92	0.028	-82.9	25.1	1.46	0.49	1.9
2015E	7,567	86	0.026	-7.0	27.0	1.48	0.48	1.8
2016E	8,120	121	0.037	41.9	19.0	1.52	0.47	2.5
2017E	8,710	147	0.045	21.3	15.7	1.57	0.45	2.9

Sources: Company data, GF Securities (HK)

Note: Calculated based on diluted shares.

Figure 1: Financial statements

Income Statement						Balance Sheet					
Year end Dec (Rmb m)	2013	2014	2015E	2016E	2017E	Year end Dec (Rmb m)	2013	2014	2015E	2016E	2017E
Land drilling rigs	5,665	4,771	4,256	4,311	4,498	Cash and cash equivalents	1,275	1,442	1,711	2,010	2,302
Rigs parts and components	1,777	2,469	2,765	3,042	3,291	Inventories	2,801	2,981	2,902	3,022	3,137
O&G engineering services	409	443	377	565	678	Trade and other receivables	3,961	4,509	4,146	4,227	4,295
Offshore modules and parts	197	130	169	203	243	Other current assets	1,643	1,328	1,323	1,334	1,345
Turnover	8,047	7,813	7,567	8,120	8,710	Total current assets	9,681	10,260	10,082	10,592	11,080
YoY (%)	58.8	(2.9)	(3.1)	7.3	7.3	Property, plant & equipment	2,148	2,838	2,784	2,736	2,694
COGS	(6,142)	(6,183)	(6,053)	(6,488)	(6,940)	Land use right	362	403	396	390	383
Gross profit	1,905	1,630	1,514	1,632	1,770	Intangible assets	214	213	178	144	109
YoY (%)	9.1	(14.5)	(7.1)	7.8	8.4	Other non-current assets	1,825	1,785	1,785	1,785	1,785
Other revenue	176	113	73	74	76	Total non-current assets	4,548	5,238	5,143	5,054	4,971
Other net income/(loss)	7	(7)	0	0	0	Total assets	14,229	15,498	15,225	15,646	16,052
Selling expenses	(524)	(638)	(605)	(633)	(679)	Short-term borrowings	3,274	2,807	2,947	3,095	3,249
General and administrative	(596)	(688)	(651)	(682)	(732)	Trade and other payables	4,241	5,247	4,809	4,977	5,134
Other operating expenses	(121)	(13)	(12)	(13)	(14)	Other current liabilities	247	152	155	165	177
EBIT	848	396	319	378	420	Total current liabilities	7,762	8,205	7,911	8,237	8,561
Net finance costs	(139)	(273)	(189)	(194)	(197)	Long-term borrowings	1,458	2,320	2,238	2,188	2,093
Share of profit from jce/asso.	(8)	0	0	0	0	Other non-current liabilities	51	0	0	0	0
Pre-tax profit	701	124	130	184	224	Total non-current liabilities	1,509	2,329	2,247	2,197	2,102
Income tax expense	(126)	(13)	(27)	(39)	(47)	Total liabilities	9,270	10,535	10,158	10,434	10,663
After tax profit	575	110	103	146	177	Share capital	301	301	301	301	301
Minority interest	(38)	(18)	(17)	(24)	(29)	Reserves	4,463	4,428	4,514	4,635	4,782
Net profit	538	92	86	121	147	Equity attri. to shareholders	4,763	4,729	4,815	4,936	5,083
YoY (%)	1.5	-82.9	-6.8	41.9	21.3	Minority interests	195	235	252	276	306
						Total equity	4,959	4,964	5,066	5,212	5,389

Cash Flow Statement						Financial Ratio					
Year end Dec (Rmb m)	2013	2014E	2015E	2016E	2017E		2013	2014	2015E	2016E	2017E
Pre-tax profit	701	124	130	184	224	Gross margin (%)	23.7	20.9	20.0	20.1	20.3
Tax paid	(165)	(124)	(25)	(35)	(42)	EBIT margin (%)	10.5	5.1	4.2	4.7	4.8
Dep'n and amortization	241	314	396	389	383	Net margin (%)	6.7	1.2	1.1	1.5	1.7
Change in working capital	(1,295)	44	10	(37)	(32)	ROA (%)	3.8	0.6	0.6	0.8	0.9
Others	193	(40)	(0)	(0)	(0)	ROE (%)	11.3	1.9	1.8	2.5	2.9
Cash from operations	(324)	319	511	502	533	Net gearing (%)	59.9	64.9	66.9	61.2	54.9
Capital expenditure	(1,177)	(422)	(300)	(300)	(300)	Interest coverage (x)	6.1	1.5	1.7	2.0	2.1
Others	(513)	306	0	0	0	Current ratio	1.2	1.3	1.3	1.3	1.3
Cash from investing	(1690)	(116)	(300)	(300)	(300)						
Change in borrowings	2,748	396	58	97	60						
Dividend paid	(150)	(152)	0	0	0						
Others	(285)	(243)	0	0	0						
Cash from financing	2313	0	58	97	60						
FX change	(9)	(36)	0	0	0						
Net change in cash	290	168	269	299	292						

Sources: Company data, GF Securities (HK)

Rating definitions

Benchmark: Hong Kong Hang Seng Index
Time horizon: 12 months

Company ratings	
Buy	Stock expected to outperform benchmark by more than 15%
Accumulate	Stock expected to outperform benchmark by more than 5% but not more than 15%
Hold	Expected stock relative performance ranges between -5% and 5%
Underperform	Stock expected to underperform benchmark by more than 5%
Sector ratings	
Positive	Sector expected to outperform benchmark by more than 10%
Neutral	Expected sector relative performance ranges between -10% and 10%
Cautious	Sector expected to underperform benchmark by more than 10%

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