Honghua Group

Offshore risks and guiding to breakeven; gearing unlikely to change

Underweight

0196.HK, 196 HK

Price: HK$0.91

Price Target: HK$0.60

China
Asia Oils

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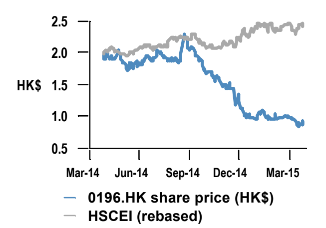
Price Performance



	YTD	1m	3m	12m
Abs	-8.1%	-7.1%	-6.2%	-54.3%
Rel	-7.6%	-4.6%	-5.4%	-75.3%

Honghua's management briefing highlighted slowing orders, risks that its offshore projects get delayed and did not give us confidence that the business is able to maintain the current level of gearing. Backlog is likely to collapse further and Honghua's strategic move into offshore could not come at a worse time, in our view. We remain UW.

- **Losses in Offshore/OFS; looking for breakeven in FY15**: Management pointed to a cRmb150mn loss in the offshore segment and cRmb200mn loss in the OFS segment as key reasons for the weak results. The company aims to break even in these segments in FY15.
- **Controlling leverage; cRmb10bn of facilities:** The company plans to maintain its leverage ratio around current levels with some possible improvement y/y (net debt to equity was c74% at year-end 2014) and notes that there is still a cRmb10bn credit facility available to the company.
- **Backlog of Rmb7.8bn at end-Feb; Offshore delays expected:** Backlog includes land rig (Rmb2.6bn), Parts (Rmb1.2bn), Offshore (Rmb3.8bn), and OFS (Rmb200mn). The company believes that they should see delays in their offshore orders of several months (e.g. Tiger III & IV); see limited risk in cancellations of Tiger orders and believe will deliver on the semi-sub.
- **China/US to remain slow in FY15; Middle East/Russia a focus:** Management believes China revenues will likely remain subdued in FY15 and will focus on international clients with opportunities in the Middle East and Russia. US orders likely to slow on weaker activity.
- **Possible restructure/repurchase of debt:** Honghua acknowledges that they are considering options with their bonds trading at c54 (per Bloomberg) and will update the market should any plans to restructure debt are decided upon.
- **Reduced FY15/17 EPS by c10%; maintain Underweight rating and Dec-15 PT of HK$0.60.**

Honghua Group (Reuters: 0196.HK, Bloomberg: 196 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (Rmb mn)	5,068	8,047	7,813	5,125	5,413	10,010
Net Profit (Rmb mn)	529	538	92	57	143	471
EPS (Rmb)	0.17	0.17	0.03	0.02	0.04	0.15
DPS (Rmb)	0.05	0.05	0.00	0.00	0.01	0.04
Revenue growth (%)	45.4%	58.8%	(2.9%)	(34.4%)	5.6%	84.9%
EPS growth (%)	218.1%	2.5%	(83.0%)	(38.3%)	152.5%	229.3%
ROCE	9.0%	8.7%	3.8%	2.7%	3.6%	7.2%
ROE	12.4%	11.7%	3.7%	1.2%	2.9%	9.2%
P/E (x)	4.4	4.3	25.2	40.9	16.2	4.9
P/BV (x)	0.5	0.5	0.5	0.5	0.5	0.4
EV/EBITDA (x)	4.1	5.4	8.6	7.3	6.5	5.8
Dividend Yield	6.4%	6.6%	0.0%	0.7%	1.7%	5.7%

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

Company Data	
Shares O/S (mn)	3,241
Market Cap (Rmb mn)	2,362
Market Cap ($ mn)	380
Price (HK$)	0.91
Date Of Price	26 Mar 15
Free Float(%)	40.0%
3M - Avg daily vol (mn)	5.01
3M - Avg daily val (HK$ mn)	4.99
3M - Avg daily val ($ mn)	0.6
HSCEI	1,1919.69
Exchange Rate	7.75
Price Target End Date	31-Dec-15

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

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Key catalyst for the stock price:	Upside risks to our view:	Downside risks to our view:
1) Updates on semi-sub progress and other offshore projects 2) Interim results (Aug 2015)	1) Offshore order wins 2) Improving land rig backlog; Middle East contract upside	1) Increased competition in the oilfield services sector from international and SOE entrants 2) Speed and direction of political reform limiting growth of private firms 3) Discounting for offshore orders; cash cycle concerns

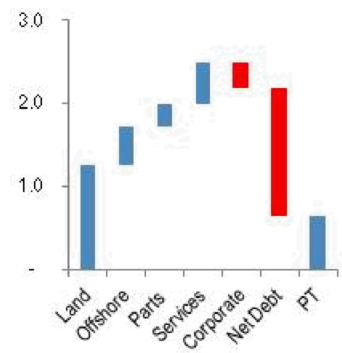
Key financial metrics	FY14	FY15E	FY16E	FY17E
Revenues (LC)	7,813	5,125	5,413	10,010
Revenue growth (%)	(3%)	(34%)	6%	85%
EBITDA (LC)	711	733	807	1,285
EBITDA margin (%)	9%	14%	15%	13%
Tax rate (%)	11%	13%	13%	13%
Net profit (LC)	92	57	143	471
EPS (LC)	0.029	0.018	0.045	0.148
EPS growth (%)	(83%)	(38%)	153%	229%
DPS (LC)	-	0.005	0.013	0.041
BVPS (LC)	1.562	1.578	1.620	1.756
Operating cash flow (LC mn)	319	1,128	445	(1,432)
Free cash flow (LC mn)	(281)	1,012	302	(1,743)
Interest cover (X)	NM	NM	NM	NM
Net margin (%)	2%	1%	3%	5%
Sales/assets (X)	0.53	0.37	0.45	0.67
Debt/equity (%)	103%	86%	82%	114%
Net debt/equity (%)	74%	58%	55%	89%
ROE (%)	4%	1%	3%	9%
Key model assumptions	**FY14E**	**FY15E**	**FY16E**	**FY17E**
Group EBITDA Margin (%)	9%	14%	15%	13%
Capital Expenditures (LC mn)	(778)	(300)	(300)	(500)
Effective Tax Rate (%)	11%	13%	13%	13%

Source: Company and J.P. Morgan estimates.

Valuation and price target basis

Our Dec-15 price target of HK$0.6 is derived from a sum-of-the-parts methodology, with each of Honghua's four business segments valued using an EV/EBITDA multiple.

Price Target Breakdown



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

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY15E	FY16E
10 day increase in trade receivables	0%	0%	(2%)	(2%)
10 day increase in inventory days	0%	0%	(1%)	(1%)
RMB 100mn increase in CAPEX	1%	1%	(1%)	(1%)
0.5% increase in EBIT Margins	3%	3%	6%	6%

Source: J.P. Morgan estimates.

JPMe vs. consensus, change in estimates		
EPS	FY15E	FY16E
JPMe old	0.020	0.046
JPMe new	0.018	0.045
% chg	(12%)	(3%)
Consensus	0.064	0.087

Source: Company and J.P. Morgan estimates.

China Oil & Gas/OFS coverage comparative metrics

	JPM	JPM	CMP	Upside	Mkt Cap	P/E(x)		P/B(x)		EV/EBITDA(x)		YTD
Company name	Rating	PT (LC)	LC	to PT (%)	($bn)	15Y	16Y	15Y	16Y	15Y	16Y	Perf (%)
PETROCHINA-H	N	8.20	8.35	(1.8)	330.2	20.3	15.5	1.0	1.0	10.7	8.8	(2.9)
SINOPEC CORP-H	N	5.70	6.05	(5.8)	118.3	21.1	13.8	0.9	0.9	8.3	7.1	(3.2)
CNOOC	UW	9.00	10.56	(14.8)	61.2	19.7	11.9	1.2	1.3	5.0	4.1	1.1
SPC-H	UW	1.50	2.68	(44.0)	7.6	30.7	17.9	1.2	1.2	14.6	14.0	18.1
CBC-H	OW	4.80	2.76	73.9	1.7	6.1	6.0	0.6	0.6	3.3	3.0	0.4
COSL-H	UW	10.60	12.32	(14.0)	13.5	12.6	11.9	1.0	1.0	11.7	11.0	(8.5)
ANTON OILFIELD	UW	0.60	1.34	(55.2)	0.4	107.3	53.6	1.1	1.1	10.7	8.0	(19.8)
SPT ENERGY	N	1.40	1.35	3.7	0.3	12.0	9.8	0.8	0.7	5.3	5.1	(5.6)
HILONG HOLDING	OW	2.90	1.96	48.0	0.4	7.1	5.8	0.8	0.7	6.3	5.4	8.3
HONGHUA	UW	0.60	0.91	(34.1)	0.4	40.9	16.2	0.5	0.5	7.3	6.5	(8.1)

Source: Bloomberg, Company and J.P. Morgan estimates. Prices as of COB March 26th 2015.

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Key points:

- **Land rig business was stable in FY14; outlook grim:** The land rig segment operations were stable in FY14, per management, with gross margins expanding to c29% from c24% in FY13. Pricing was down c10% y/y on a blended basis (based on deliveries) with digital controlled rig prices falling c6% y/y and conventional rig prices falling c44%. The company holds a backlog of Rmb2.6bn for 40 rigs, implying pricing down c5% in FY15; we forecast revenues for the segment at Rmb2.8bn. The focus of the business will remain on the Middle East where spending has remained relatively robust and the company has build a track record with NDC, KDC, and Abraj; Middle East rigs tend to be higher specification/drill depth and command better margins.
- **Parts business strong in FY14; mud pumps deliveries up 77%:** Parts and components business saw a c40% increase in revenues y/y on the back of a 77% increase in mud pump sales (194 units vs. 109 units in FY13). The outlook for the business remains mixed with slowdowns in the US likely to hamper growth; the company is still working on testing the 6000HHP fracturing pump with Baker Hughes in the US.
- **OFS impacted by oil price and anticorruption campaign:** Management highlighted the impact of falling oil prices in 2H14 and the anticorruption campaign at the NOCs as key reasons for the losses in the OFS segment. The company looks to be breakeven this year, but with an Rmb200bn backlog we see limited improvement in the segment.
- **Looking to control leverage; still have cRmb10bn of facilities:** The Company plans to maintain their leverage ratio around current levels with some possible improvement y/y (net debt to equity was c74% at year-end 2014) and notes that there is still cRmb10bn credit facility available to the company.
- **Backlog of Rmb7.8bn at end-Feb; Offshore delays expected:** Backlog includes land rig orders of Rmb2.6bn (40 units), parts orders of Rmb1.2bn, Offshore orders of Rmb3.8bn (expect delays), and OFS orders of Rmb200mn. The company believes that they should see delays in their offshore orders of several months (e.g. Tiger III & IV); the semi-sub project will soon complete engineering. Management believes there is very limited cancellation risk on Tiger packages and are confident on the outlook for the semi-sub project at these dayrates and believe that there will need to be are placement cycle for mid/deep water rigs. We note that the semi-sub project (US$320mn tender) was signed with a 10% down/90% at completion payment terms, a major risk to Honghua's capital position should the buyer default or want to back out of the deal.
- **Possible restructure/repurchase of debt:** The company acknowledges that they are considering options with their bonds currently trading at c54 (per Bloomberg) and will update the market should any plans to restructure debt are decided upon.

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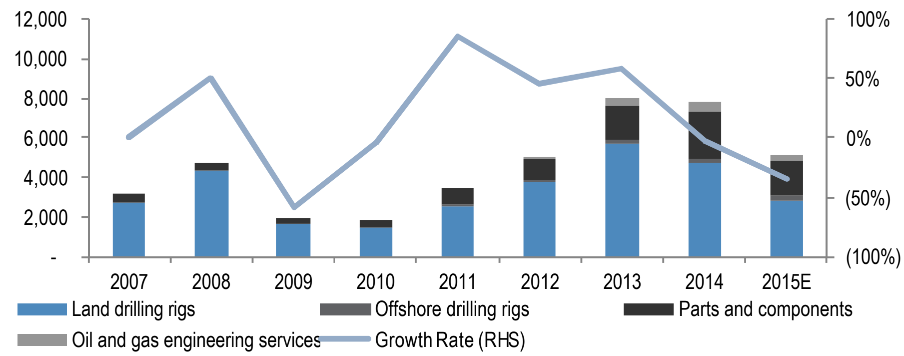
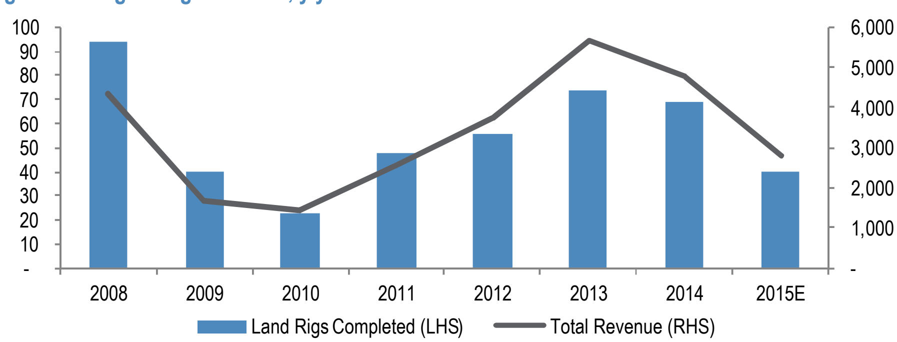
Figure 1: Honghua segment revenues, y/y

Rmb mn



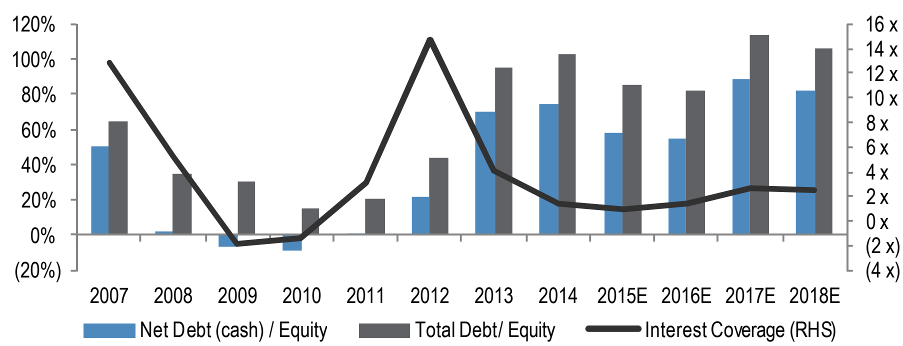
Source: J.P. Morgan estimates, Company data.

Figure 2: Honghua rig deliveries, y/y



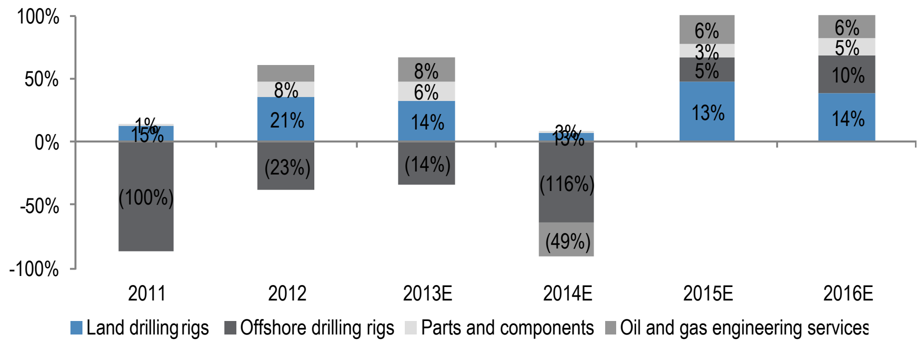
Source: J.P. Morgan estimates, Company data.

Figure 3: Honghua leverage profile



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

Figure 4: Honghua segmental EBIT margins, y/y



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

FY15/17 EPS cut by c10%; maintain Dec-15 PT of HK$0.6

We have adjusted our FY15/17 EPS forecast by an average of c10% p.a. to reflect 2H14 results, backlog update, and to take more conservative stance on offshore orders (see here for details). We maintain our Dec-15 PT for Honghua of HK$0.60, based on our sum-of-the-parts methodology, with each of Honghua's business segments valued using an EV/EBITDA multiple.

Table 1: Honghua EPS revisions

	New	Old	Cons	Change (%)	Vs. cons (%)
15Y	0.02	0.02	0.06	(12%)	(72%)
16Y	0.04	0.05	0.09	(3%)	(48%)
17Y	0.15	0.17	NM	(15%)	NM

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

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Investment Thesis, Valuation and Risks

Honghua Group *(Underweight; Price Target: HK$0.60)*

Investment Thesis

Honghua Group Ltd. (0196.HK) manufactures land drilling rigs, rig parts, and components for the oil and natural gas industry. The firm has expanded its production capabilities into offshore oil services and drilling equipment. Additionally the firm has begun to offer oilfield service and technical advising. Our negative view on the firm is based on:

- **Deteriorating land rig backlog** – We see increasing risks in land rig orders and deliveries; we note that in the last collapse in oil prices (2009) Honghua's delivered rigs dropped by c60% from 94 in 2008 to 40 in 2009, further dropping to 23 in FY10.
- **Limited domestic OFS growth visibility…** – Honghua's OFS segment is levered to China and with growing competition from SOE OFS competitors (e.g. SOSC, CNPC Drilling) and risk of continued slow activity levels, we believe that the private service providers will see more pressures in securing contracts.
- **Offshore backlog, but execution a funding a risk –** Honghua has secured a number of offshore contracts (tankers, semisub); however, with a larger working capital requirement for these contracts and a already high level of leverage, we have concerns around impacts of execution issues on the balance sheet.

Valuation

Our Dec-2015 price target of HK$0.60/share is derived from a sum-of-the-parts methodology, with each of Honghua's four business segments valued using an EV/EBITDA multiple. Find below the breakdown of SOTP valuation:

Segment	EBITDA (mn Rmb)	EV/ EBITDA	EV
Land drilling rigs	434	7.3	3,170
Offshore drilling rigs	136	9.0	1,223
Parts and components	114	6.0	683
Oil and gas engineering	207	6.0	1,244
Unallocated	(159)	5.0	(793)
Total	733		5,528
Net (Debt) / Cash			(3,920)
Equity value			1,608
NOSH			3,200
Fair Value (Rmb)			0.5
Price Target (HK$)			0.6

Source: J.P. Morgan estimates

Risks to Rating and Price Target

Risk to our rating and price target include: 1) increased competition in the oilfield services sector from international and SOE entrants; 2) speed and direction of political reform limiting growth of private firms; and 3) discounting for offshore orders; cash cycle concerns.

Honghua Group: Summary of Financials

Income Statement

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	8,047	7,813	5,125	5,413	10,010
% change Y/Y	58.8%	(2.9%)	(34.4%)	5.6%	84.9%
EBITDA	1,089	710	733	807	1,285
% change Y/Y	32.7%	(34.8%)	3.2%	10.1%	59.2%
EBIT	848	396	289	377	867
% change Y/Y	26.1%	(53.3%)	(27.0%)	30.3%	129.8%
EBIT Margin	10.5%	5.1%	5.6%	7.0%	8.7%
Net Interest	(139)	(190)	(212)	(180)	(217)
Earnings before tax	701	124	78	197	649
% change Y/Y	(1.2%)	(82.4%)	(36.9%)	152.5%	229.3%
Tax	(126)	(13)	(10)	(26)	(84)
as % of EBT	17.9%	10.9%	13.0%	13.0%	13.0%
Net income (reported)	538	92	57	143	471
% change Y/Y	1.5%	(82.9%)	(38.3%)	152.5%	229.3%
Shares outstanding	3,165	3,178	3,178	3,178	3,178
EPS (reported)	0.17	0.03	0.02	0.04	0.15
% change Y/Y	1.4%	(82.9%)	(38.3%)	152.5%	229.3%

Cash flow statement

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
EBIT	848	396	289	377	867
Depr. & amortization	314	443	430	418	436
Change in working capital	(786)	169	235	(109)	(1,601)
Taxes	(126)	(13)	(10)	(26)	(84)
Cash flow from operations	(324)	319	1,128	445	(1,432)
Capex	(1,177)	(778)	(300)	(300)	(500)
Disposal/(purchase)	-	-	-	-	-
Net Interest	(139)	(190)	(212)	(180)	(217)
Other	(513)	662	(30)	(32)	(59)
Free cash flow	(1,386)	(281)	1,012	302	(1,743)
Equity raised/(repaid)	(102)	0	0	0	0
Debt raised/(repaid)	2,748	0	(824)	(73)	2,123
Other	(177)	0	0	0	0
Dividends paid	(156)	0	(16)	(40)	(132)
Beginning cash	984	1,275	1,442	1,400	1,400
Ending cash	1,275	1,442	1,400	1,400	1,400
DPS	0.05	0.00	0.00	0.01	0.04

Balance sheet

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	1,275	1,442	1,400	1,400	1,400
Accounts receivable	3,961	4,509	2,808	2,966	5,485
Inventories	2,801	2,981	1,679	1,782	3,710
Others	1,643	1,328	845	866	1,264
Current assets	9,681	10,260	6,732	7,015	11,859
LT investments	74	118	118	118	118
Net fixed assets	2,148	2,838	2,741	2,657	2,785
Total Assets	14,229	15,498	11,959	12,169	17,571
Liabilities					
Short-term loans	3,274	2,807	2,756	3,456	6,352
Payables	4,241	5,247	2,479	2,631	5,477
Others	247	152	152	152	152
Total current liabilities	7,762	8,205	5,387	6,239	11,981
Long-term debt	1,458	2,320	1,547	773	0
Other liabilities	0	9	9	9	9
Total Liabilities	9,270	10,535	6,943	7,022	11,990
Shareholder's equity	4,763	4,729	4,781	4,913	5,346
BVPS (Rmb)	1.57	1.56	1.58	1.62	1.76

Ratio Analysis

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
EBITDA margin	13.5%	9.1%	14.3%	14.9%	12.8%
EBIT margin	10.5%	5.1%	5.6%	7.0%	8.7%
Net margin	6.7%	2.2%	1.1%	2.6%	4.7%
Sales per share growth	60.2%	(3.3%)	(34.4%)	5.6%	84.9%
Sales growth	58.8%	(2.9%)	(34.4%)	5.6%	84.9%
Net profit growth	1.5%	(82.9%)	(38.3%)	152.5%	229.3%
EPS growth	1.4%	(67.4%)	(67.6%)	152.5%	229.3%
Interest coverage (x)	7.8	3.7	3.5	4.5	5.9
Net debt to equity	69.7%	74.2%	57.9%	55.0%	88.7%
Sales/assets	0.7	0.5	0.4	0.4	0.7
Assets/equity	2.6	3.1	2.9	2.5	2.9
ROE	11.7%	3.7%	1.2%	2.9%	9.2%
ROCE	8.7%	3.8%	2.7%	3.6%	7.2%

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

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Honghua Group (0196.HK, 196 HK) Price Chart

Date	Rating	Share Price (HK$)	Price Target (HK$)
13-Nov-13	OW	2.36	3.50
21-Mar-14	N	2.05	2.90
18-Aug-14	OW	1.98	2.90
09-Nov-14	N	1.44	1.60
15-Feb-15	UW	0.99	0.60

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Nov 13, 2013.

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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