Equity Research

February 7, 2018

CICC SH-HK Stock Connect

Sinopec Engineering Group

Momentum gathered for new upturn

Initial Coverage

Investment positives

We initiate coverage of Sinopec Engineering Group with a BUY rating and a target price of HK$9.70, equivalent to 4.0x 2019e EV/EBITDA or 10x 2019e P/E and offering 23% upside.

Why a BUY rating?

- **Order momentum building.** We believe SEG's order backlog bottomed at end-2016. Order flow improved in 2017 and should gather momentum in 2018, particularly with a new management incentive scheme taking effect at end-2017. We expect Sinopec's Rmb200bn capex plan to bring high-margin EPC contracts to SEG, driving up its margins and earnings.
- **To rebound from 2017 troughs.** SEG's backlog trough at end-2016 suggests a new low in revenue in 2017—but we see more meaningful indicators in 2017 and 2018 orders, expecting them to boost SEG's earnings by 41% this year and 13% in 2019.
- **Strong cash flow to support higher dividend payout, rerating.** We expect strengthening free cash flow and SEG's net cash position to allow the firm to increase its dividend payout to more than 45%, particularly given the new incentive scheme.

How do we differ from the market? We attribute the recent negative earnings alert for 2017 mainly to one-off losses on currency exchange and asset impairment. Our earnings forecasts for 2018 and 2019 are a respective 13% and 9% higher than consensus projections.

Potential catalysts: New orders, higher dividend payout, and new growth from the environmental business.

Financials and valuation

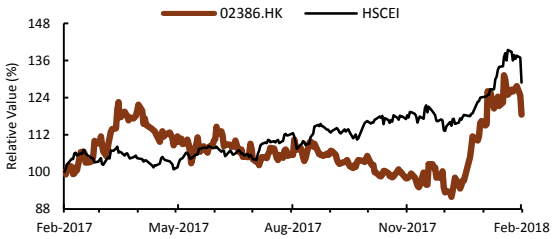
We expect SEG to post 2017, 2018 and 2019 EPS (before one-off items) of Rmb0.46, Rmb0.65 and Rmb0.74, for a CAGR of 25%. The stock offers a 2019e dividend yield of 5% based on the current price.

Risks

Project delays, less than expected clients, FX risks

Initiate with BUY

Ticker	02386.HK
CICC investment rating	* BUY
Last close	HK$7.87
CICC target	HK$9.70
52wk price range	HK$8.80~6.10
Market cap (bn)	HK$35
Daily value (mn)	HK$91.58
Shares outstanding (mn)	4,428
Free float (%)	33
Daily volume (mn sh)	11.21
Business sector	Oil & Gas



(Rmb mn)	2016A	2017e	2018e	2019e
Revenue	39,375	35,651	45,467	48,953
(+/-)	-13.5%	-9.5%	27.5%	7.7%
Net profit	1,663	2,053	2,885	3,269
(+/-)	-49.9%	23.4%	40.5%	13.3%
EPS	0.38	0.46	0.65	0.74
BPS	5.69	6.01	6.47	6.94
DPS	0.15	0.19	0.27	0.33
CPS	1.02	0.94	0.85	1.19
P/E	18.8	14.5	9.6	8.4
P/B	1.2	1.1	1.0	0.9
EV/EBITDA	7.3	5.5	3.2	2.0
Dividend yield	2.1%	2.8%	4.4%	5.3%
ROAA	2.8%	3.5%	4.6%	4.7%
ROAE	6.7%	7.9%	10.4%	11.0%

Source: Wind, Bloomberg, company data, CICC Research

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Please read carefully the important disclosures at the end of this report

Financial summary

Financial statement (Rmb mn)	2016A	2017e	2018e	2019e
Income statement				
Revenue	39,375	35,651	45,467	48,953
COGS	-35,085	-31,018	-39,165	-41,963
Selling expenses	-107	-125	-127	-127
Administrative expenses	-1,160	-1,248	-1,591	-1,713
Other ops income (expense)	-849	0	0	0
Operating profit	1,060	2,226	3,264	3,729
Finance costs	419	496	567	614
Other income (expense)	875	0	0	0
Profit before income tax	2,369	2,738	3,847	4,359
Income tax	-706	-684	-962	-1,090
Minority interest	0	0	0	0
Net profit	1,663	2,053	2,885	3,269
EBITDA	2,658	2,975	4,048	4,548
Recurrent net income	1,630	2,053	2,885	3,269
Balance sheet				
Cash and bank balances	11,862	13,562	14,576	18,659
Trade and bill receivables	9,990	8,595	10,962	10,729
Inventories	1,197	1,020	1,288	1,380
Other current assets	27,924	28,006	32,695	33,113
Total current assets	50,972	51,183	59,520	63,881
Fixed assets and CIP	4,174	3,875	3,767	3,648
Intangible assets and others	3,672	3,658	3,519	3,405
Total non-current assets	7,846	7,533	7,286	7,053
Total assets	58,818	58,716	66,806	70,934
Short-term borrowings	0	0	0	0
Trade and bill payables	14,217	13,597	17,168	18,395
Other current liabilities	16,500	15,628	18,084	18,927
Total current liabilities	30,717	29,226	35,252	37,322
Long-term borrowings	0	0	0	0
Total non-current liabilities	2,899	2,899	2,899	2,899
Total liabilities	33,616	32,125	38,151	40,221
Share capital	4,428	4,428	4,428	4,428
Retained profit	20,770	22,159	24,223	26,280
Equity	25,202	26,591	28,655	30,713
Total liabilities & equity	58,818	58,716	66,806	70,934
Cash flow statement				
Pretax profit	2,369	2,738	3,847	4,359
Depreciation & amortization	723	749	783	819
Change in working capital	2,377	1,898	703	1,792
Others	-947	-1,223	-1,556	-1,703
Cash flow from operations	4,522	4,162	3,777	5,267
Capital expenditure	-398	-470	-570	-620
Others	-2,966	-1,412	-1,456	563
Cash flow from investing	-3,363	-1,882	-2,026	-57
Equity financing	0	0	0	0
Bank borrowings	0	0	0	0
Others	-1,131	-580	-737	-1,127
Cash flow from financing	-1,131	-580	-737	-1,127
Foreign exchange gain (loss)	428	0	0	0
Net changes in cash	456	1,700	1,014	4,083

Financial ratios	2016A	2017e	2018e	2019e
Growth ability				
Revenue	-13.5%	-9.5%	27.5%	7.7%
Operating profit	-69.5%	110.0%	46.6%	14.2%
EBITDA	-40.5%	11.9%	36.1%	12.4%
Net profit	-49.9%	23.4%	40.5%	13.3%
Profitability				
Gross margin	10.9%	13.0%	13.9%	14.3%
Operating margin	2.7%	6.2%	7.2%	7.6%
EBITDA margin	6.7%	8.3%	8.9%	9.3%
Net margin	4.2%	5.8%	6.3%	6.7%
Liquidity				
Current ratio	1.66	1.75	1.69	1.71
Quick ratio	1.62	1.72	1.65	1.67
Cash ratio	0.39	0.46	0.41	0.50
Liabilities / assets	57.2%	54.7%	57.1%	56.7%
Net debt / equity	net cash	net cash	net cash	net cash
Return				
RoA	2.8%	3.5%	4.6%	4.7%
RoE	6.7%	7.9%	10.4%	11.0%
Per-share data				
EPS (Rmb)	0.38	0.46	0.65	0.74
BPS (Rmb)	5.69	6.01	6.47	6.94
DPS (Rmb)	0.15	0.19	0.27	0.33
Cash flow per share (Rmb)	1.02	0.94	0.85	1.19
Valuation				
P/E	18.8	14.5	9.6	8.4
P/B	1.2	1.1	1.0	0.9
EV/EBITDA	7.3	5.5	3.2	2.0
Dividend yield	2.1%	2.8%	4.4%	5.3%

Source: Company data, CICC Research

Company description

Sinopec Engineering Group (SEG), a subsidiary of Sinopec Group, is the engineering leader in China's refining, petrochemicals and new coal chemicals markets. The company possesses high professional qualifications including grade-A comprehensive engineering design certification and national class-A certification on construction contracting. It has participated in all 16 refining projects with 10Mt/a+ capacity and six of the seven largest ethylene projects with 1Mt/a+ capacity in China in the past decade.

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Investment highlights

China's refining and chemical engineering leader. Sinopec Engineering Group is one of China's most capable engineering groups, with proprietary technologies and expertise in oil refining, petrochemical processing (ethylene cracking furnaces, polyethylene, polypropylene and butadiene), coal to chemical processing, and advanced construction. SEG participated in all 16 of China's mega refining projects and six of the seven largest ethylene projects in the past decade.

Order momentum building. We believe SEG's order backlog bottomed at end-2016. Order flow improved in 2017 and should gather momentum in 2018, particularly with a new management incentive scheme taking effect at end-2017. We expect Sinopec's Rmb200bn capex plan for new industrial zones to high-value, high-margin EPC contracts to SEG, driving up its margins and earnings. We expect SEG's net profit after tax and revenue to increase at 2016–2019 CAGRs of 25% and 8%, respectively, and its ROE to recover from 7% in 2016 to 11% by 2019.

Figure 1: Forecasts by segments

						YoY				CAGR
Rmb mn	2015	2016	2017E	2018E	2019E	2015~16	2016~17E	2017~18E	2018~19E	2016~19E
Revenue	**45,498**	**39,375**	**35,651**	**45,467**	**48,953**	**-13%**	**-9%**	**28%**	**8%**	**8%**
Engineering, consulting and licensing	2,626	2,612	3,074	3,752	4,112	-1%	18%	22%	10%	16%
EPC Contracting	27,839	20,641	20,445	25,797	28,099	-26%	-1%	26%	9%	11%
Construction	14,914	15,964	11,555	15,369	16,217	7%	-28%	33%	6%	1%
Equipment manufacturing	120	159	577	549	524	32%	264%	-5%	-5%	49%
Gross profit	**6,157**	**4,291**	**4,633**	**6,302**	**6,989**	**-30%**	**8%**	**36%**	**11%**	**18%**
Engineering, consulting and licensing	926	903	1,106	1,463	1,624	-2%	23%	32%	11%	22%
EPC Contracting	3,994	2,520	2,556	3,483	3,934	-37%	1%	36%	13%	16%
Construction	1,242	838	924	1,306	1,378	-33%	10%	41%	6%	18%
Equipment manufacturing	(5)	30	46	49	52	-698%	56%	7%	6%	21%
EBITDA	4,464	2,658	2,975	4,048	4,548	-40%	12%	36%	12%	20%
EBIT	3,845	1,935	2,226	3,264	3,729	-50%	15%	47%	14%	24%
NPAT	**3,318**	**1,663**	**2,053**	**2,885**	**3,269**	**-50%**	**23%**	**41%**	**13%**	**25%**
EPS (Rmb/sh)	**0.75**	**0.38**	**0.46**	**0.65**	**0.74**	**-50%**	**23%**	**41%**	**13%**	**25%**
ROE	13%	7%	8%	10%	11%					
Revenue mix										
Engineering, consulting and licensing	6%	7%	9%	8%	8%					
EPC Contracting	61%	52%	57%	57%	57%					
Construction	33%	41%	32%	34%	33%					
Equipment manufacturing	0%	0%	2%	1%	1%					
Gross profit mix										
Engineering, consulting and licensing	2%	2%	3%	3%	3%					
EPC Contracting	9%	6%	7%	8%	8%					
Construction	3%	2%	3%	3%	3%					
Equipment manufacturing	0%	0%	0%	0%	0%					
Gross margin	**14%**	**11%**	**13%**	**14%**	**14%**					
Engineering, consulting and licensing	35%	35%	36%	39%	40%					
EPC Contracting	14%	12%	13%	14%	14%					
Construction	8%	5%	8%	9%	9%					
Equipment manufacturing	-4%	19%	8%	9%	10%					
EBITDA margin	10%	7%	8%	9%	9%					
EBIT margin	8%	5%	6%	7%	8%					

Source: Company data, CICC Research

To rebound from 2017 troughs. SEG's backlog trough at end-2016 suggests a new low in revenue in 2017. Despite a recent negative earnings alert for 2017—which we attribute mainly to one-off losses on currency exchange and asset impairment totaling around Rmb0.8bn after tax—we believe SEG's recurrent earnings still rose approximately 25% to Rmb2.1bn. While we estimate the firm's net profit for 2017 at a record-low Rmb1.2bn (or Rmb0.27/share), we see more meaningful indicators in 2017 and 2018 orders, expecting them to boost earnings by 41% in 2018 and 13% in 2019. Our forecasts are a respective 13% and 9% above consensus projections.

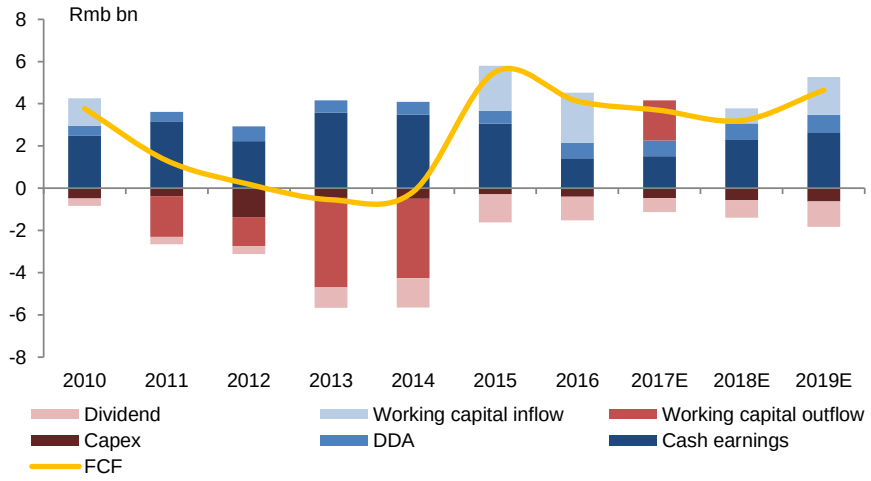
Domestic recovery to lead the way. Stricter environmental regulations are likely to reshape China's refining & chemical (R&C) industry by prompting the relocation of widely scattered facilities to a few regional bases, requiring the building of large, more efficient integrated facilities to replace small, obsolete ones. Engineering firms like SEG, with advanced technologies and full EPC qualifications, should benefit.

Sinopec Corporation, SEG's sister company, has unveiled a Rmb200bn capex plan to build four mega domestic R&C bases (namely, the "Maozhan" base in Guangdong province, Zhenhai in Zhejiang, Nanjing in Jiangsu, and Shanghai) during the 13th five-year period, which should boost SEG's order flow. Preliminary construction on the Maozhan base (i.e., the Sino-Kuwaiti, or Zhongke, refining & petrochemical complex) began in late 2016. We expect SEG to win EPC orders for project worth more than Rmb15bn in 1H18. We also expect EPC orders from Sinopec Gulei (in Fujian province) and Zhenhai (in Zhejiang province) over 2019–2020.

Incentive scheme to stimulate growth. China's State-owned Assets Supervision and Administration Commission (SASAC) approved SEG's application for a management incentive program in early December, and SEG's board approved a share appreciation rights scheme on December 20. Under the scheme, 89 management members have been granted the rights 13.143mn shares (around 0.3% of total outstanding) exercisable at HK$6.35. All the units, if exercised, shall be settled in cash, and thus should have no dilution impact on current shareholders. Preconditions for exercise are as follows: SEG's ROE must exceed 10% each year over 2018–2020 (up from the 7% trough in 2016), and revenue must surpass Rmb45.0bn in 2018, Rmb47.9bn in 2019 and Rmb50.9bn in 2020, for a 2016–2020 CAGR of 6.6%.

Strong cash flow to support higher dividend payout. An asset-light business nature and good working-capital management has helped SEG maintain decent free cash flows and a dividend payout ratio of around 40%, despite a sector-wide order downturn over the past three years. Going forward, we expect the firm's strengthening FCF and net cash position to allow it to increase its dividend payout to more than 45%, particularly given the new incentive scheme. The stock offers a 2019e dividend yield of 5% based on its current price.

Figure 2: Cash flow analysis



Source: Company data, CICC Research

We expect SEG to post 2017, 2018 and 2019 EPS (before one-off items) of Rmb0.46, Rmb0.65 and Rmb0.74, for a CAGR of 25%. Earnings for 2017 are likely to hurt by one-offs (as detailed on the previous page), but we still believe recurrent earnings rose around 25% to Rmb2.1bn. Our EPS forecasts for 2018 and 2019 are a respective 9% and 13% above consensus projections.

DCF+DDM valuation. We value SEG using a DCF model for 2018–2028 assuming a 9.6% WACC and deriving a present value of its EV of Rmb18bn. For terminal value, we adopt a DDM model assuming an 11.1% cost of equity and 30% long-term dividend payout ratio, deriving a present value of terminal value of Rmb1.5bn. Summing the two, we arrive at a total EV of Rmb19.6bn and estimate SEG's equity value at Rmb35.4bn or HK$10.1/share, equivalent to 11x 2019e P/E and 4.3x 2019e EV/EBITDA.

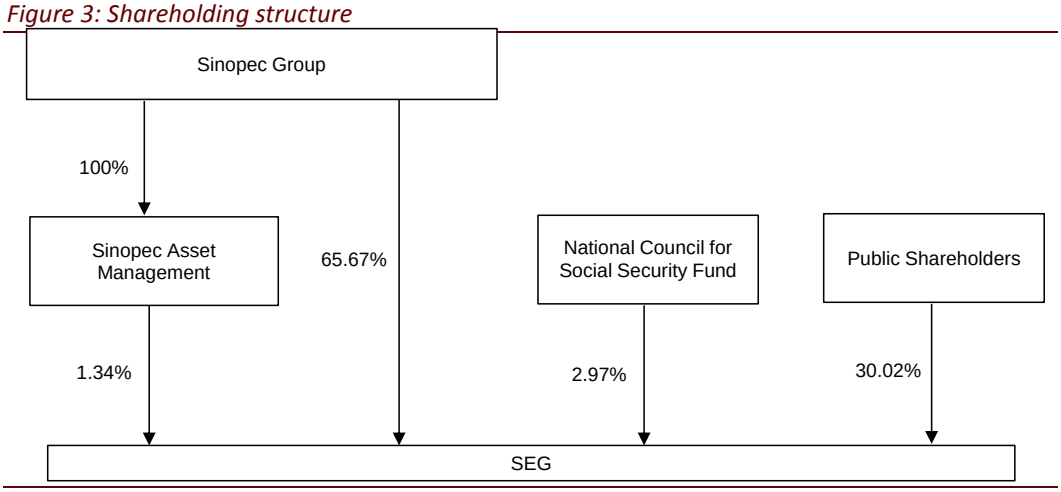
Company description

The engineering leader in China's R&C markets

SEG is a subsidiary of Sinopec Group and the sister firm of Sinopec Corp., China's integrated energy and materials giant. The leading engineering firm in China's refining, petrochemical, and coal chemical markets, it listed in Hong Kong in 2013 and offers solutions ranging from licensing, consulting, and engineering to EPC contracting, construction, and equipment manufacturing.

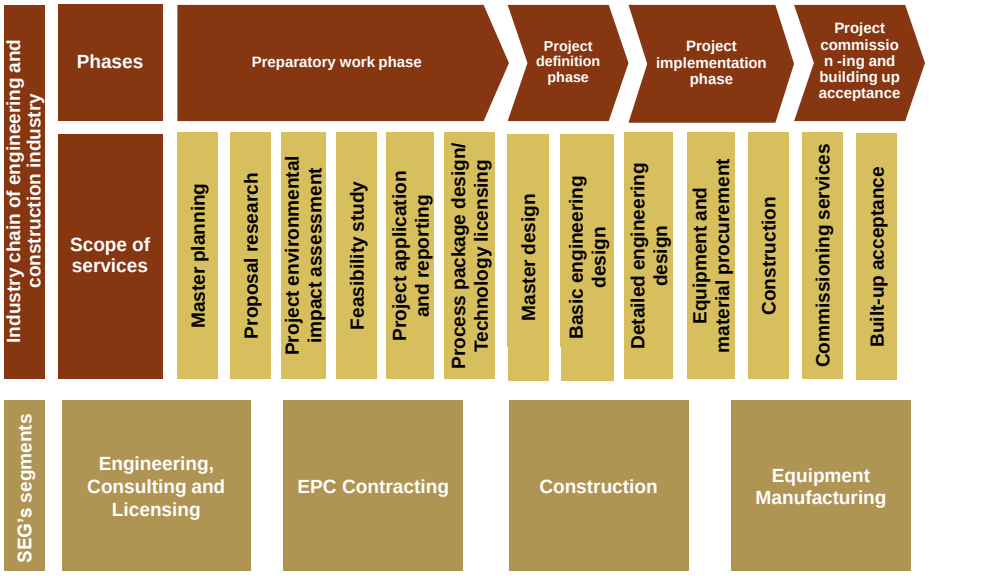
SEG has 10 wholly owned subsidiaries in China: SEI (Beijing), LPEC (Luoyang), SSEC (Shanghai), SNEC (Ningbo), SNEI (Nanjing), SGEC (Guangzhou); FCC, SFCC and TCC (the nation's 4th, 5th and 10th largest construction companies); and Sinopec Ningbo Technology Research Institute. It also has an extensive overseas network, including fully owned subsidiaries in Saudi Arabia, Nigeria, Singapore and the US, as well as branches in the United Arab Emirates (Abū Dhabi), Kazakhstan, and Russia. SEG possesses professional qualifications in China, including grade-A certification in comprehensive engineering design and national class-A certification in construction contracting.

Figure 3: Shareholding structure



Source: Company data, CICC Research

Figure 4: A full range of services



Source: Company data, CICC Research

Cutting-edge technology and broad market coverage. SEG is one of China's most capable engineering groups, with proprietary technologies and expertise in oil refining, petrochemical processing (ethylene cracking furnaces, polyethylene, polypropylene and butadiene), coal to chemical processing, and advanced construction. SEG participated in all 16 of China's mega refining projects and six of the seven largest ethylene projects in the past decade.

The company has formulated the vast majority of China's national and industrial standards for not only refining and petrochemicals, but also pharmaceutical chemicals and emission reductions. It boasts a number of key technological advantages, including the following.

- **Oil refining**: Crude and vacuum distillation, fluid catalytic cracking and continuous catalytic reforming; processing of heavy, high-sulfur, and/or high acidity crude oil; production of high-quality refined oil.
- **Petrochemicals**: A complete series of processing technologies for ethylene and polyolefin; technologies used in large chemical projects (especially >1Mtpa super-large ethylene or PTA units); refining and chemicals integration.
- **Alternative energy**: Natural gas purification, large LNG storage & transport facilities, natural gas-to-liquid fuel, bio-jet fuels, bio-diesels, and using coal as a substitute for oil in chemical production.
- **New coal chemicals**: Coal gasification, coal-to-syngas, coal-to-methanol, methanol-to-olefin (DMTO and SMTO) and olefin polymerization and IGCC technologies. The firm also developed or participated in developing all MTO technologies now commercially used in China.
- **Pharmaceutical chemicals:** Bio-fermentation and chemical synthesis, natural medicine extraction, and clean pharmaceutical chemical engineering.
- **Inorganic chemicals:** Advanced technologies for the production of sulfuric acid, phosphate fertilizer and phosphate compound fertilizer, and cutting-edge technologies for low-level heat recovery to improve energy efficiency at sulfuric acid plants.

Broad clientele and respected corporate image. Top-tier domestic and overseas clients respect SEG for its technological advantages and dependable project execution. Chinese clients include Sinopec Corp, CNOOC, PetroChina, SinoChem, Yanchang Petroleum, ChemChina, and leading private refining and petrochemical firms. Overseas, the company counts international majors such as ExxonMobil, Shell, BP, BASF and Saudi Aramco as clients. In 1H17, ExxonMobil placed SEG on its list of strategic EPC contractors, a move that should give the firm a big step up in winning recognition from other top-tier overseas clients.

Figure 5: Major customers in China and overseas

Large Chinese energy and chemical companies		Large international energy and chemical companies	
Sinopec	Yanchang Petroleum	ExxonMobil Corporation	SABIC
CNOOC	China Shenhua	Shell	Saudi Aramco
PetroChina	ChinaCoal	BP	Bayer AG
SinoChem	hemChina	BASF	Novartis
		KazMunaiGas	

Source: Company data, CICC Research

Earnings to bottom out

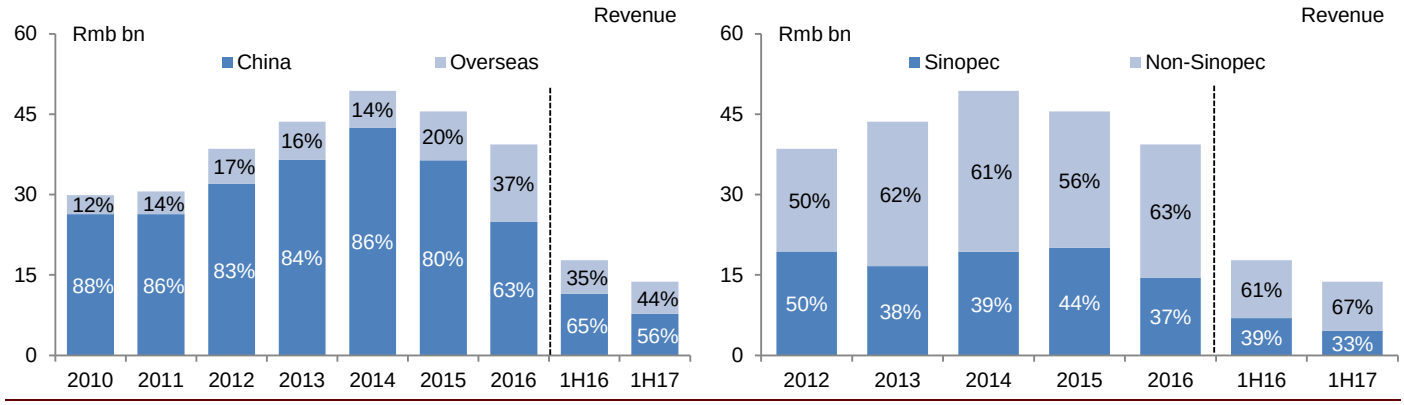
SEG's earnings last peaked in 2013 on a coal-to-chemicals boom in China. Its net profit grew from Rmb2.9bn in 2010 to a record Rmb3.7bn in 2013. Coal-to-chemical and petrochemical investments shrank significantly after oil prices slumped in 2014, and many projects were delayed or cancelled in a sector downturn. SEG's recurrent net profit fell at a 23% compounded annual rate over 2013–2016 to only Rmb1.7bn in 2016, before likely rebounded to around Rmb2.1bn before one-off items in 2017.

Order and margin gains to drive rebound. We expect SEG's new orders and backlog to recover from 2017 lows, and its revenue and profits to rebound from 2018. We believe net profits will grow faster than revenue as an increasing portion of high-margin EPC contracts among new orders drive up margins. We expect SEG's NPAT and revenue to increase at 2016–2019 CAGRs of 25% and 8%, respectively, and its ROE to recover from 7% in 2016 to 11% by 2019.

Orders to improve in quantity and quality terms. A new round of R&C capacity expansion in China boosted SEG's 1–3Q17 new orders 87% YoY to Rmb27bn. We expect SEG to be the key beneficiary of Sinopec's plan to build four R&C industrial bases, all of which should bring high-value, high-margin EPC contracts to the firm. We estimate that projects in Guangdong province (Zhongke) in 1H18, Fujian province (Gulei) in 2019e, and Zhejiang province (Zhenhai) in 2020e will each contribute Rmb10-18bn worth of EPC orders for SEG.

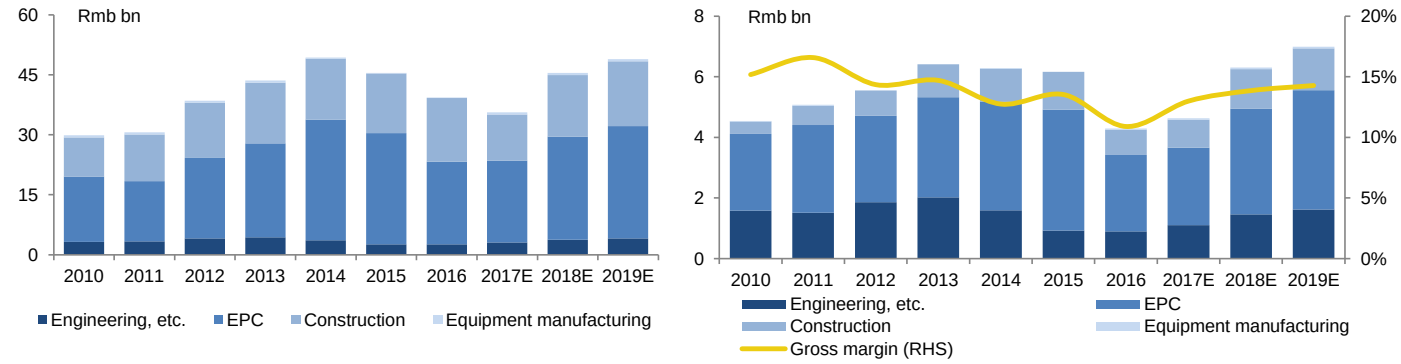
Overseas, SEG has established a strong network with leading global engineering companies to participate in joint bidding. We also see huge revenue potential in closer cooperation with energy majors such as ExxonMobil and Shell, which may pave the way for SEG to win independent EPC bids. The Chinese government's Belt and Road Initiative should also lead to more orders from Asia and Africa.

Figure 6: Revenue by market (left) and client (right)



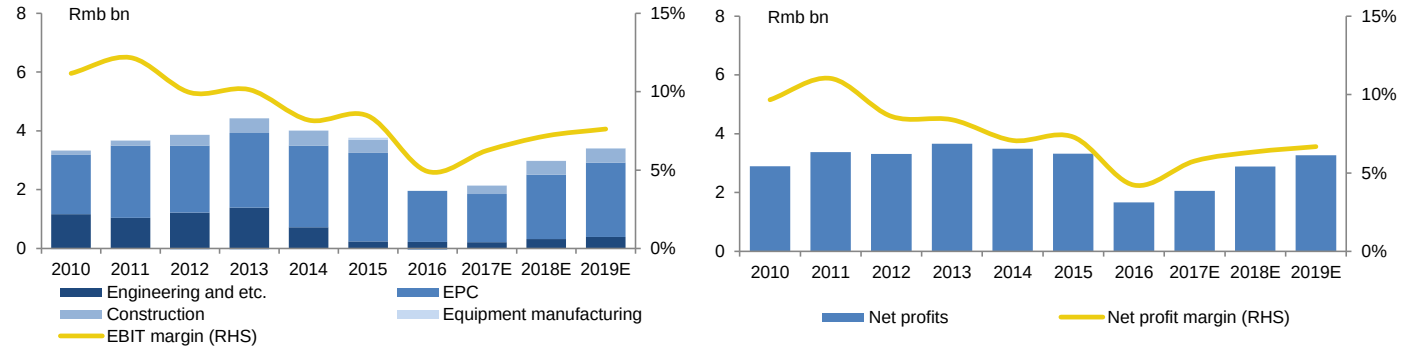
Source: Company data, CICC Research

Figure 7: Revenue (left) and gross profit by segment (right)



Source: Company data, CICC Research

Figure 8: EBIT by segment (left); net profit and margin (right)



Source: Company data, CICC Research

Figure 9: Results review

Rmb mn	2015	2016	YoY	1H15	2H15	1H16	2H16	1H17	YoY	HoH
Income statement										
Revenue	**45,498**	**39,375**	**-13%**	**20,905**	**24,593**	**17,735**	**21,641**	**13,764**	**-22%**	**-36%**
Cost of sales	-39,341	-35,085	-11%	-17,884	-21,457	-15,526	-19,559	-11,551	-26%	-41%
Gross profit	**6,157**	**4,291**	**-30%**	**3,021**	**3,136**	**2,209**	**2,082**	**2,213**	**0%**	**6%**
Other income	368	875	138%	52	316	261	614	93	-64%	-85%
Selling and marketing expenses	-101	-107	6%	-42	-59	-41	-65	-48	16%	-27%
Administrative expenses	**-1,116**	**-1,160**	**4%**	**-474**	**-642**	**-422**	**-739**	**-477**	**13%**	**-35%**
Research and development costs	-1,185	-1,113	-6%	-460	-725	-399	-714	-377	-6%	-47%
Other operating expenses	-280	-849	203%	-175	-105	-449	-400	-562	25%	40%
Other gains/(losses), net	2	-1	n.m	1	2	0	-2	0	122%	n.m
Operating Profit	**3,845**	**1,935**	**-50%**	**1,922**	**1,923**	**1,159**	**775**	**844**	**-27%**	**9%**
Finance income, net	375	419	12%	191	184	217	201	216	0%	7%
Share of profits/(losses) of JV	0	0	47%	-0	1	-1	1	-0	-26%	-142%
Share of profits/(losses) of associates	20	15	-22%	6	14	6	10	4	-28%	-58%
Profit before taxation	**4,240**	**2,369**	**-44%**	**2,119**	**2,121**	**1,382**	**988**	**1,064**	**-23%**	**8%**
Income tax expenses	-922	-706	-23%	-408	-514	-303	-403	-229	-24%	-43%
Profit for the year/period	**3,318**	**1,663**	**-50%**	**1,711**	**1,607**	**1,079**	**584**	**835**	**-23%**	**43%**
Non controlling interests	-0	0	n.m	0	-0	-0	0	0	n.m	n.m
Profit attributable to equity owners	**3,318**	**1,663**	**-50%**	**1,711**	**1,607**	**1,079**	**585**	**835**	**-23%**	**43%**
Recurring NPAT	**3,091**	**1,630**	**-47%**	**1,783**	**1,564**	**1,151**	**541**	**1,386**	**20%**	**156%**
** excl. non-recurring items*										
Balance Sheet Summary										
Total assets	58,404	58,818	1%	55,216	58,404	55,985	58,818	57,194	2%	-3%
Shareholder funds	24,635	25,198	2%	23,732	24,635	24,907	25,198	25,703	3%	2%
Total equity	24,639	25,202	2%	23,736	24,639	24,911	25,202	25,707	3%	2%
Net debt /(cash)	-11,406	-11,862	4%	-10,052	-11,406	-8,531	-11,862	-9,025	6%	-24%
Net gearing	-46%	-47%	n.m	-42%	-46%	-34%	-47%	-35%	n.m	n.m
Per Share Information										
Reported EPS (Rmb)	0.75	0.38	-50%	0.39	0.36	0.24	0.13	0.19	-23%	43%
Recurring EPS (Rmb)	0.70	0.37	-47%	0.40	0.35	0.26	0.12	0.31	20%	156%
DPS (Rmb)	0.30	0.15	-49%	0.11	0.18	0.07	0.08	0.06	-22%	-28%
	43%	41%								
Margins & Returns Analysis										
Gross margin	14%	11%	-2.6ppt	14%	13%	12%	10%	16%	3.6ppt	6.5ppt
Net margin	7%	4%	-3.1ppt	8%	7%	6%	3%	6%	0.0ppt	3.4ppt
Selling expenses / revenue	0.2%	0.3%	0.0ppt	0.2%	0.2%	0.2%	0.3%	0.3%	0.1ppt	0.0ppt
Administrative expenses / revenue	2.5%	2.9%	0.5ppt	2.3%	2.6%	2.4%	3.4%	3.5%	1.1ppt	0.0ppt
Effective tax rate	22%	30%	8.1ppt	19%	24%	22%	41%	22%	-0.4ppt	-19.3ppt
ROA	6%	3%	-2.9ppt	3%	3%	2%	1%	1%	-0.5ppt	0.5ppt
ROE	13%	7%	-6.9ppt	7%	7%	4%	2%	3%	-1.1ppt	0.9ppt

Source: Company data, CICC Research

Figure 10: Segment results review

Rmb mn	2015	2016	YoY	1H15	2H15	1H16	2H16	1H17	YoY	HoH
Revenue	**45,498**	**39,375**	**-13%**	**20,905**	**24,593**	**17,735**	**21,641**	**13,764**	**-22%**	**-36%**
Engineering, consulting and licensing	2,626	2,612	-1%	1,337	1,288	796	1,816	1,099	38%	-40%
EPC Contracting	27,839	20,641	-26%	12,892	14,947	9,285	11,356	7,440	-20%	-34%
Construction	14,914	15,964	7%	6,634	8,280	7,588	8,376	5,072	-33%	-39%
Equipment manufacturing	120	159	32%	42	78	66	93	153	133%	66%
Segment EBIT	**3,768**	**1,863**	**-51%**	**1,896**	**1,872**	**1,104**	**759**	**813**	**-26%**	**7%**
Engineering, consulting and licensing	237	226	-5%	265	-28	-116	342	193	n.m	-43%
EPC Contracting	3,015	1,737	-42%	1,353	1,662	1,027	710	479	-57%	-32%
Construction	441	-96	-122%	278	163	206	-302	138	-285%	n.m
Equipment manufacturing	76	-4	-105%	1	75	-14	10	3	n.m	-73%
Segment EBIT margin	**8%**	**5%**	**-3.6ppt**	**9%**	**8%**	**6%**	**4%**	**6%**	**-0.3ppt**	**2.4ppt**
Engineering, consulting and licensing	9%	9%	-0.4ppt	20%	-2%	-15%	19%	18%	n.m	-1.2ppt
EPC Contracting	11%	8%	-2.4ppt	10%	11%	11%	6%	6%	-4.6ppt	0.2ppt
Construction	3%	-1%	-3.6ppt	4%	2%	3%	-4%	3%	0.0ppt	n.m
Equipment manufacturing	63%	-2%	n.m	2%	96%	-20%	10%	2%	n.m	-8.7ppt

Source: Company data, CICC Research

Figure 11: Project execution smooth despite sector downturn

Rmb bn	2010A	2011A	2012A	2013A	2014A	2015A	2016A
Engineering, consulting and licensing							
Backlog at year-beginning	5.0	4.5	5.0	5.0	6.1	6.5	6.9
New orders	2.7	3.9	4.1	5.4	4.1	3.0	2.7
Order completed	-3.2	-3.4	-4.1	-4.4	-3.6	-2.6	-2.6
Backlog at year-end	4.5	5.0	5.0	6.1	6.5	6.9	7.0
Revenue	3.2	3.4	4.1	4.4	3.6	2.6	2.6
Revenue/(Backlog at year-beg. + New orders)	42%	40%	45%	42%	36%	27%	27%
EPC contracting							
Backlog at year-beginning	30.0	35.4	53.4	56.8	74.0	82.1	78.7
New orders	21.7	33.0	23.5	51.2	38.2	35.5	10.9
Order completed	-16.3	-15.0	-20.1	-34.0	-30.1	-39.0	-20.6
Backlog at year-end	35.4	53.4	56.8	74.0	82.1	78.7	68.9
Revenue	16.3	15.0	20.1	23.5	30.1	27.8	20.6
Revenue/(Backlog at year-beg. + New orders)	32%	22%	26%	22%	27%	24%	23%
Construction							
Backlog at year-beginning	8.1	14.5	15.7	14.0	12.2	15.2	14.3
New orders	16.2	12.8	12.2	13.4	18.3	14.0	13.8
Order completed	-9.8	-11.7	-13.8	-15.2	-15.3	-14.9	-16.0
Backlog at year-end	14.5	15.7	14.0	12.2	15.2	14.3	12.1
Revenue	9.8	11.7	13.8	15.2	15.3	14.9	16.0
Revenue/(Backlog at year-beg. + New orders)	40%	43%	50%	55%	50%	51%	57%
Equipment manufacturing							
Backlog at year-beginning	0.3	0.4	0.4	0.3	0.3	0.1	0.1
New orders	0.6	0.5	0.4	0.5	0.1	0.1	0.2
Order completed	-0.6	-0.5	-0.5	-0.5	-0.2	-0.1	-0.2
Backlog at year-end	0.4	0.4	0.3	0.3	0.1	0.1	0.2
Revenue	0.6	0.5	0.5	0.5	0.2	0.1	0.2
Revenue/(Backlog at year-beg. + New orders)	61%	58%	66%	65%	64%	51%	51%
Total							
Backlog at year-beginning	43.4	54.7	74.4	76.1	92.6	103.9	100.0
New orders	**41.2**	**50.3**	**40.1**	**70.6**	**60.7**	**52.7**	**27.6**
Order completed	-29.9	-30.6	-38.5	-54.1	-49.3	-56.6	-39.4
Backlog at year-end	**54.7**	**74.4**	**76.1**	**92.6**	**103.9**	**100.0**	**88.2**
Revenue	**29.9**	**30.6**	**38.5**	**43.6**	**49.3**	**45.5**	**39.4**
Revenue/(Backlog at year-beg. + New orders)	35%	29%	34%	30%	32%	29%	31%

Source: Company data, CICC Research

Figure 12: Order backlog trends

Rmb bn	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	1H16	2H16	1H17	2015	2016
Orders backlog												
By business segments	**107.8**	**90.6**	**89.8**	**88.2**	**88.6**	**92.2**	**94.1**	**90.6**	**88.2**	**92.2**	**100.0**	**88.2**
Engineering, consulting and licensing	6.9	7.3	7.1	7.0	7.2	8.4	8.3	7.3	7.0	8.4	6.9	7.0
EPC contracting	88.3	73.4	73.3	68.9	68.2	70.5	69.4	73.4	68.9	70.5	78.7	68.9
Construction	12.4	9.9	9.3	12.1	13.1	13.0	15.7	9.9	12.1	13.0	14.3	12.1
Equipment manufacturing	0.1	0.1	0.1	0.2	0.1	0.3	0.6	0.1	0.2	0.3	0.1	0.2
%												
Engineering, consulting and licensing	6%	8%	8%	8%	8%	9%	9%	8%	8%	9%	7%	8%
EPC contracting	82%	81%	82%	78%	77%	76%	74%	81%	78%	76%	79%	78%
Construction	12%	11%	10%	14%	15%	14%	17%	11%	14%	14%	14%	14%
Equipment manufacturing	0%	0%	0%	0%	0%	0%	1%	0%	0%	0%	0%	0%
By business segment of customers	**107.8**	**90.6**	**89.8**	**88.2**	**88.6**	**92.2**	**94.1**	**90.6**	**88.2**	**92.2**	**100.0**	**88.2**
Oil refining	32.4	31.3	31.5	32.2	32.0	30.5	29.5	31.3	32.2	30.5	33.0	32.2
Petrochemicals	21.9	19.5	18.0	17.6	19.0	23.8	27.1	19.5	17.6	23.8	22.7	17.6
Coal-to-chemicals	35.3	22.1	22.1	20.2	19.3	19.0	18.3	22.1	20.2	19.0	26.2	20.2
Other industries	18.2	17.7	18.2	18.1	18.3	18.9	19.3	17.7	18.1	18.9	18.1	18.1
%												
Oil refining	30%	34%	35%	37%	36%	33%	31%	34%	37%	33%	33%	37%
Petrochemicals	20%	22%	20%	20%	22%	26%	29%	22%	20%	26%	23%	20%
Coal-to-chemicals	33%	24%	25%	23%	22%	21%	19%	24%	23%	21%	26%	23%
Other industries	17%	20%	20%	21%	21%	20%	20%	20%	21%	20%	18%	21%
By regions	**107.8**	**90.6**	**89.8**	**88.2**	**88.6**	**92.2**	**94.1**	**90.6**	**88.2**	**92.2**	**100.0**	**88.2**
Domestic	73.3	60.0	58.4	55.6	58.2	64.3	69.3	60.0	55.6	64.3	63.3	55.6
Overseas	34.5	30.7	31.4	32.6	30.4	27.8	24.8	30.7	32.6	27.8	36.7	32.6
%												
Domestic	68%	66%	65%	63%	66%	70%	74%	66%	63%	70%	63%	63%
Overseas	32%	34%	35%	37%	34%	30%	26%	34%	37%	30%	37%	37%
By customers	**107.8**	**90.6**	**89.8**	**88.2**	**88.6**	**92.2**	**94.1**	**90.6**	**88.2**	**92.2**	**100.0**	**88.2**
Sinopec Group	41.9	40.1	39.9	37.8	38.9	39.7	41.6	40.1	37.8	39.7	42.2	37.8
Overseas	65.9	50.5	49.9	50.4	49.7	52.5	52.5	50.5	50.4	52.5	57.7	50.4
%												
Sinopec Group	39%	44%	44%	43%	44%	43%	44%	44%	43%	43%	42%	43%
Overseas	61%	56%	56%	57%	56%	57%	56%	56%	57%	57%	58%	57%

Source: Company data, CICC Research

Figure 13: New order trends

Rmb bn	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	1H16	2H16	1H17	2015	2016
New orders												
By business segments	**4.4**	**4.0**	**6.2**	**21.3**	**5.8**	**11.4**	**10.1**	**8.4**	**19.2**	**17.2**	**52.7**	**27.6**
Engineering, consulting and licensing	0.4	0.7	0.3	2.4	0.6	1.9	0.6	1.1	1.5	2.6	3.0	2.7
EPC Contracting	2.2	1.8	2.5	8.4	1.7	7.3	2.6	4.0	6.9	9.0	35.5	10.9
Construction	1.7	1.5	3.4	10.4	3.5	1.9	6.6	3.2	10.6	5.4	14.0	13.8
Equipment manufacturing	0.0	0.0	0.0	0.2	0.0	0.3	0.4	0.1	0.1	0.3	0.1	0.2
%												
Engineering, consulting and licensing	10%	18%	4%	11%	11%	17%	6%	14%	8%	15%	6%	10%
EPC Contracting	50%	44%	41%	39%	29%	64%	25%	47%	36%	52%	67%	40%
Construction	39%	37%	55%	49%	60%	17%	65%	38%	55%	31%	27%	50%
Equipment manufacturing	1%	1%	0%	1%	0%	3%	4%	1%	1%	2%	0%	1%
By business segment of customers	**4.4**	**4.0**	**6.2**	**21.3**	**5.8**	**12.0**	**9.6**	**8.4**	**19.2**	**17.8**	**52.7**	**27.6**
Oil refining	1.1	1.6	1.5	8.5	1.6	2.4	2.6	2.7	7.3	4.0	14.0	10.0
Petrochemicals	1.7	0.7	1.2	6.2	3.1	6.8	5.2	2.4	5.0	9.9	11.1	7.4
Coal-to-chemicals	0.1	0.8	1.4	1.1	0.1	0.9	0.4	0.8	1.7	1.0	7.5	2.6
Other industries	1.5	1.0	2.1	5.5	1.0	1.9	1.4	2.5	5.1	2.9	20.1	7.5
%												
Oil refining	25%	39%	25%	40%	27%	20%	27%	32%	38%	22%	27%	36%
Petrochemicals	39%	17%	20%	29%	53%	60%	51%	29%	26%	57%	21%	27%
Coal-to-chemicals	2%	19%	23%	5%	2%	8%	4%	10%	9%	6%	14%	9%
Other industries	33%	25%	33%	26%	18%	16%	14%	29%	26%	17%	38%	27%
By regions	**4.4**	**4.0**	**6.2**	**12.9**	**5.8**	**12.0**	**9.6**	**8.4**	**19.2**	**17.8**	**52.7**	**27.6**
Domestic	4.4	3.8	3.3	5.7	5.7	10.8	9.2	8.1	9.1	16.5	33.5	17.2
Overseas	-	0.3	2.9	7.2	0.1	1.2	0.4	0.3	10.1	1.3	19.1	10.4
%												
Domestic	100%	94%	53%	44%	99%	90%	96%	97%	47%	93%	64%	62%
Overseas	0%	6%	47%	56%	1%	10%	4%	3%	53%	7%	36%	38%
By customers	**4.4**	**4.0**	**6.2**	**12.9**	**5.8**	**12.0**	**9.6**	**8.4**	**19.2**	**17.8**	**52.7**	**27.6**
Sinopec Group	3.2	1.7	1.9	3.3	5.7	0.7	3.7	4.9	5.2	6.5	21.0	10.1
Overseas	1.2	2.3	4.3	9.6	0.1	11.2	5.9	3.5	13.9	11.3	31.7	17.5
%												
Sinopec Group	73%	42%	31%	26%	99%	6%	38%	58%	27%	36%	40%	37%
Overseas	27%	58%	69%	74%	1%	94%	62%	42%	73%	64%	60%	63%

Source: Company data, CICC Research

New management incentive scheme to stimulate growth

SEG's share appreciation rights scheme (proposed in Aug 2017) was approved on December 20 at an extraordinary general meeting. Under the scheme, 89 management members have been granted the rights 13.143mn shares (around 0.3% of total outstanding) exercisable at HK$6.35.

The rights will be exercisable in three phases over 2019–2021. All the units, if exercised, shall be settled in cash, and thus should have no dilution impact on current shareholders. Preconditions for exercise are as follows: 1) SEG's ROE must exceed 10% each year over 2018–2020, up from the 7% trough in 2016); 2) revenue must surpass Rmb45.0bn in 2018, Rmb47.9bn in 2019 and Rmb50.9bn in 2020, for a 2016–2020 CAGR of 6.6%; and 3) and economic value added, or EVA,[1] must exceed Rmb2.1bn in 2018, Rmb2.2bn in 2019 and Rmb2.4bn in 2020.

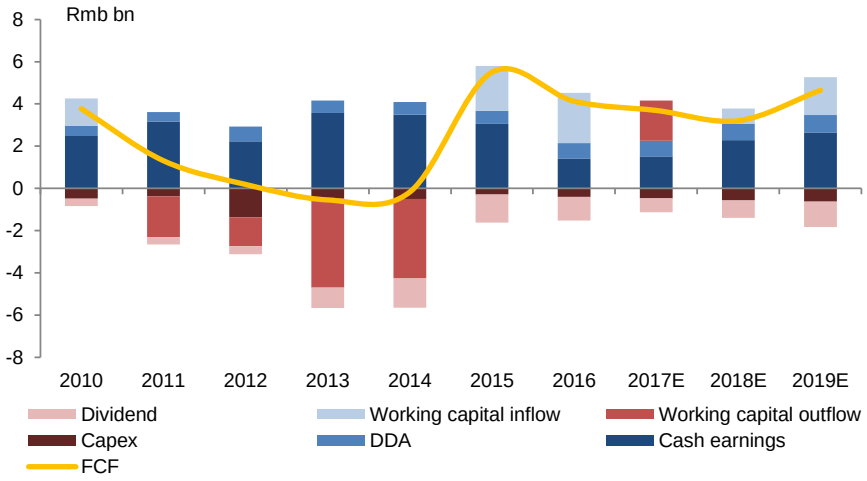
[1] EVA=Recurring net profit + (interest expenses + R&D expenses) x (1 - applicable tax rate) - Capex

Ample cash likely to support higher dividend payout

An asset-light business nature and good working-capital management has helped SEG maintain decent free cash flows and a dividend payout ratio of around 40%, despite a three-year sector-wide order downturn. Going forward, we expect the firm's strengthening FCF and net cash position to allow it to increase its dividend payout to more than 45%, particularly given the new incentive scheme. The stock offers a 2019e dividend yield of 5% based on its current price.

Meanwhile, SEG has maintained a cautious attitude toward acquisition. In August 2017, it announced its first acquisition since listing, buying a 100% equity interest in Sinopec Energy-Saving Technology Service from Sinopec Group for only Rmb90mn in cash (implying a valuation of 11x 2016 P/E and 1.4x P/B). The target generated Rmb27mn in revenue and Rmb8mn in net profit in 2016, for a net margin of approximately 30%. We do not expect any more significant acquisitions in the near term.

Figure 14: Cash flow analysis



Source: Company data, CICC Research

Industry landscape

Refining construction in China expected to take off again over 2018–2020

China's refining capacity has been declining for two years amid stricter environmental policies and capacity discipline at domestic oil majors. We expect things to turn around, however, with capacity increasing at a CAGR of around 2% from end-2016 to around 788Mt/a by 2020.

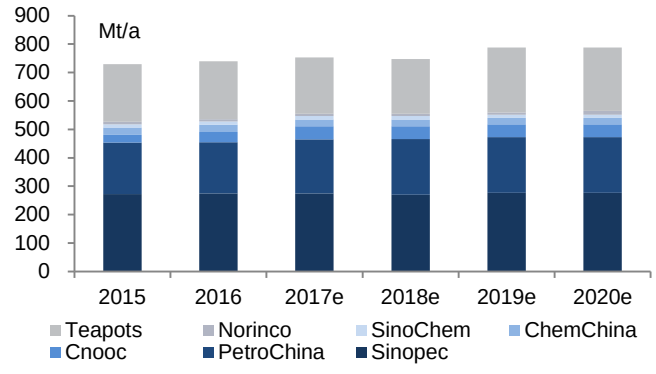
Sinopec Corp has unveiled a Rmb200bn capex plan to build four mega domestic R&C bases during the 13th five-year period, which should boost SEG's order flow. Preliminary construction on the Maozhan base began in late 2016. We expect SEG to win EPC orders for project worth more than Rmb15bn in 1H18.

Figure 15: Pipeline of major R&C projects in China

Owner	Project	Province	Location	Refining capacity (Mt)	Status	Expected operation date	Total investment (Rmb bn)	Contract amount (Rmb bn)	Major operator
Sinochem	Quanzhou Refinery	Fujian	Quanzhou	3.0	Under construction		32.5		SEG
Sinopec	Zhongke Refinery	Guangdong	Zhanjiang	10.0	Under construction	2019E	59.0	10~15	SEG
	Gulei Complex	Fujian	Zhangzhou	15.0	Groundbreaking		18.0	10~16	SEG
	Gaoqiao refinery	Shanghai	Shanghai	7.0					
	Hainan Refinery	Hainan	Hainan	5.0	Approved in 2013		41.7		
	Caofeidian Refinery	Hebei	Tangshan	15.0	Approved in 2015		28.5		
	Luoyang Refinery	Henan	Luoyang	10.0	Approved in 2014		18.0		
	Jingmen Refinery	Hubei	Jingmen	5.0	Approved in 2015				
PetroChina	Huabei Refinery Upgrade	Hebei	Renqiu	5.0	Under construction	2017E	11.0		Huanqiu
	Guangdong Refinery	Guangdong	Jieyang	20.0	Approved in 2010				
	Dongfang Refinery	Tianjin	Tianjin	13.0					
CNOOC	Daxie Refinery	Zhejiang	Ningbo	6.0		2019E	13.4		
NORINCO	Panjin Chemicals	Liaoning	Panjin	15.0	Approved in 2015				
Rongsheng	Zhejiang Petrochemical	Zhejiang	Zhoushan	20.0	Under construction		90.0	6~7	Huanqiu, SEG, CNCE, etc
Shenghong	Shenghong Petrochemical	Jiangsu	Lianyungang	16.0	Under construction		71.4	3~4	Huanqiu, SEG, CNCE, etc
Hengli	Hengli Petrochemical	Liaoning	Dalian	20.0	Under construction	2019E	74.0	2.2	Huanqiu, SEG, CNCE, etc
Xinhua Lianhe	Xinhua Lianhe Refinery	Hebei	Tangshan	15.0	Under appraisal				
Qianhai Group	Qianhai Refinery	Hebei	Tangshan	15.0	Under construction	2019E	36.0		
Total new capacity				**215**			**493.5**		

Source: Company data, CICC Research

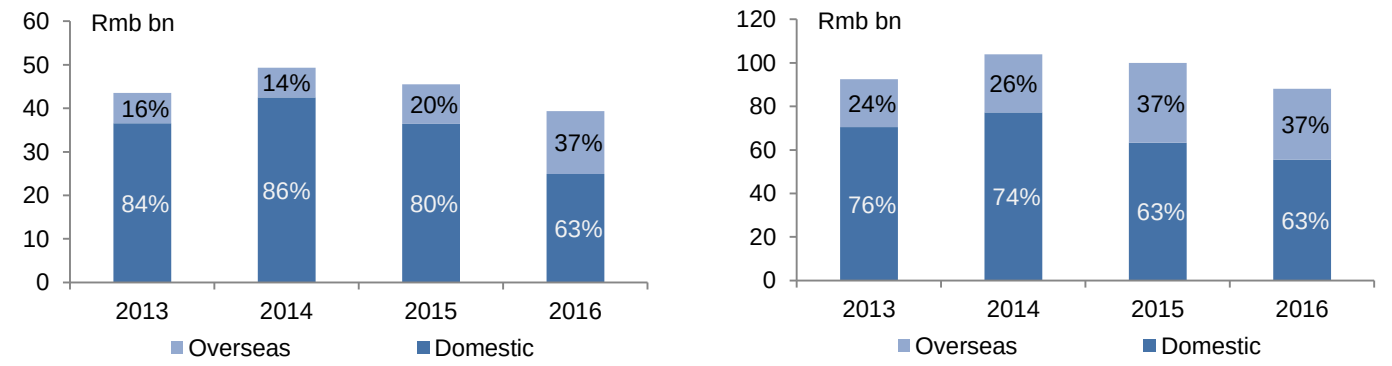
Figure 16: Refining capacity growth trends and forecasts for China (left) and globally (right)



thd bbls/day	2016	2017e	2018e	2019e	2020e	2021e	2022e	Total
Refinery Capacity Additions and Expansions								
OECD Americas	105	40	193					**233**
OECD Europe	-268		200					**200**
OECD Asia Oceania	-143	-132						**-132**
FSU	46	35	138	60	30			**263**
Non-OECD Europe								
China	70	560	60	260	420	600	320	**2,220**
Other Asia	-220	460		182	250	470	252	**1,614**
Latin America		40			33			**73**
Middle East	156	170	88	520	317	633	177	**1,905**
Africa	30	30		60	30		530	**650**
Total World	**-224**	**1,203**	**679**	**1,082**	**1,080**	**1,703**	**1,279**	**7,026**

Source: Company data, IEA, CICC Research

Figure 17: SEG's revenue (left) and order backlog (right) by region



Source: Company data, CICC Research

Major domestic players

There are four major players in China's R&C engineering market: SEG under Sinopec Group, China Petroleum Engineering Corp (600339.SH) under CNPC, China National Chemical Engineering (601117.SH), and the only private major Wison Engineering Services (2236.HK).

Figure 18: Major domestic competitors

Group	Engineering company	Ticker	Market cap. (Rmb bn)
Sinopec	SEG	2386.HK	27.7
CNPC	China Petroleum Engineering Corp (Huanqiu Contracting and Engineering)	600339.SH	24.3
CNCE Group	CNCE Co.	601117.SH	35.5
N/A	Wison Engineering	2236.HK	5.2

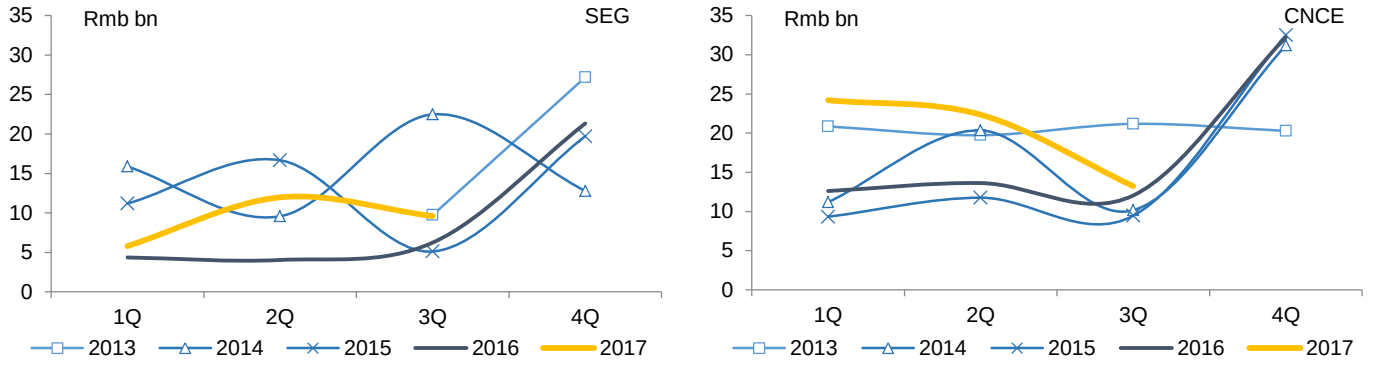
Source: Company data, CICC Research

Figure 19: Peer financial comparison

	Revenue (Rmb bn)				EBIT (Rmb mn)				EBIT margin				YoY growth in Revenue				YoY growth in EBIT			
Company	2014	2015	2016	1H17	2014	2015	2016	1H17	2014	2015	2016	1H17	2014	2015	2016	1H17	2014	2015	2016	1H17
SEG	49.3	45.5	39.4	13.8	4,039	3,845	1,935	844	8%	8%	5%	6%	13%	-8%	-13%	-22%	-8%	-5%	-50%	-27%
CNCE	69.3	63.5	53.1	24.9	4,054	3,658	2,984	1,630	6%	6%	6%	7%	12%	-8%	-16%	0%	0%	-10%	-18%	21%
CPEC	2.6	1.9	50.7	11.0	-67	-320	1,581	859	-3%	-17%	3%	8%	-14%	-27%	2526%	894%	n.m.	n.m.	n.m.	n.m.
Wison	7.0	5.4	3.0	1.4	179	205	43	41	3%	4%	1%	3%	90%	-23%	-44%	55%	n.m.	15%	-79%	98%

Note: Zhongyou Engineering's notable growth revenue and EBIT mainly due to restructuring and asset injection in 2016
Source: Company data, CICC Research

Figure 20: New orders trends at SEG and CNCE



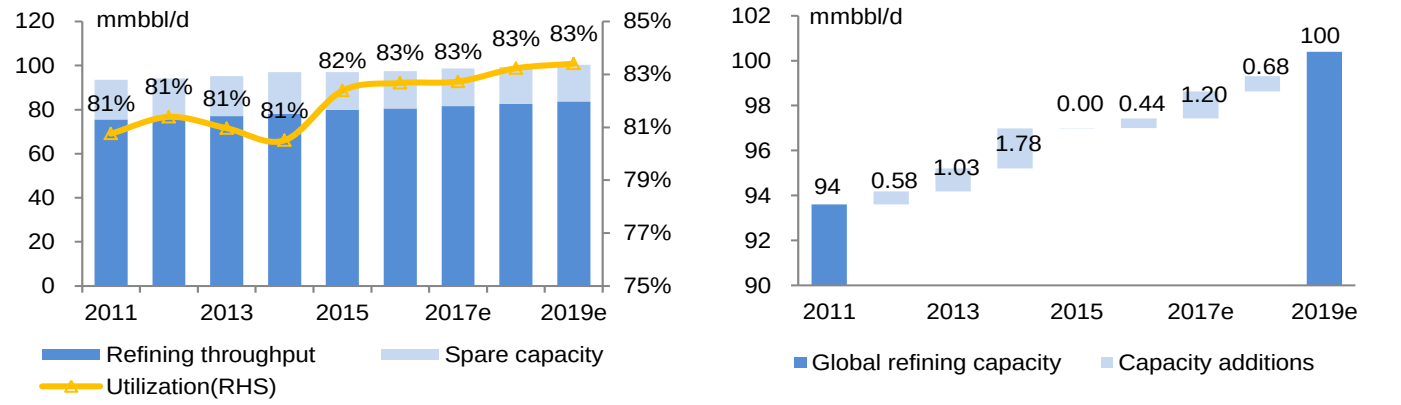
Source: Company data, CICC Research

Global refining and ethylene capacity

Global refining capacity increased slightly over 2015–2016, with around 440,000bbl/d of new capacity added each year (around a 0.2% CAGR), much less than the 1.10mmbbl/d added each year (1.2% CAGR) over 2011–2014. Meanwhile, global capacity utilization rates recovered to 83%. According to IEA, global capacity growth will accelerate over 2017–2020, with cumulative new capacity of 4.0mmbbl/d adding 4% to the end-2016 balance (for a CAGR of around 1.0%). New builds should mainly be in Asia, the Middle East, and Africa. It is worth mentioning that we believe the forecast may have overestimated the net incremental rise in global capacity, as IEA tends to underestimate the elimination of obsolete facilities in countries like China.

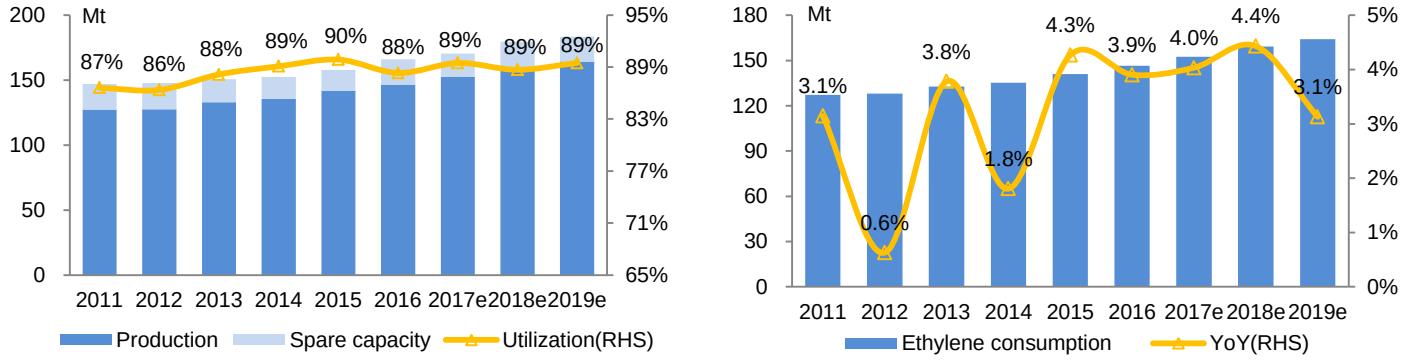
We estimate that new ethylene projects worldwide will add 21Mt/a of capacity to the global total from end-2016 to 2020, implying a 13% cumulative increase. New capacity should mainly come from North America, China and the Middle East. Meanwhile, we suspect that up to 32 small ethylene facilities, each with capacity below 200Kt/a, will gradually exit the market in coming years. If true, they could contribute a combined capacity loss of up to 4Mt/a and bring down the global net addition to 17Mt/a.

Figure 21: Growth trends for refining capacity globally (left) and in Asia-Pacific (right)



Source: BP Statistical Review of World Energy 2016, IEA, CICC Research

Figure 22: Global growth trends for ethylene capacity (left) and ethylene equivalent consumption (right)



Source: Nexant, CICC Research

Figure 23: Global forecasts for new ethylene capacity over 2017–2020

Forecast for global ethylene capacity growth				
Company	Country	Capacity	Unit	On stream
2017				
Jiangsu ShengHong S&T	China	370	thd tonnes/a	1Q2017
Ingleside Ethylene	US	544	thd tonnes/a	1Q2017
Reliance	India	1,500	thd tonnes/a	2Q2017
Dow	US	1,500	thd tonnes/a	3Q2017
Shenhua Ningxia	China	450	thd tonnes/a	3Q2017
Cornell Chemical	China	120	thd tonnes/a	4Q2017
Incremental capacity in 2017		**4,484**	thd tonnes/a	
2018				
ExxonMobil	US	1,500	thd tonnes/a	1Q2018
Formosa Plastics	US	1,250	thd tonnes/a	1Q2018
Chevron Phillips	US	1,500	thd tonnes/a	1Q2018
Indorama	US	370	thd tonnes/a	1Q2018
CNOOC Shell Petrochemicals	China	1,200	thd tonnes/a	1Q2018
Shintech	US	500	thd tonnes/a	2Q2018
Lotte Axiall	US	1,000	thd tonnes/a	4Q2018
Sasol	US	1,500	thd tonnes/a	4Q2018
Ningxia Baofeng	China	300	thd tonnes/a	4Q2018
Incremental capacity in 2018		**9,120**	thd tonnes/a	
2019				
Ilam Petrochemical	Iran	460	thd tonnes/a	1Q2019
Turkmenneftegaz	Turkmenistan	390	thd tonnes/a	1Q2019
Nanjing Chengzhi Clean Energy	China	240	thd tonnes/a	1Q2019
SP Olefins	China	650	thd tonnes/a	2Q2019
Novourengoyski GCC	Russia	340	thd tonnes/a	2Q2019
Petronas	Malaysia	1,200	thd tonnes/a	3Q2019
Shanxi Coking Co	China	300	thd tonnes/a	2019
Zhongan Lianhe Coal Chemical	China	350	thd tonnes/a	2019
Navoiazot	Uzbekistan	50	thd tonnes/a	2019
Incremental capacity in 2019		**3,980**	thd tonnes/a	
2020				
OPRIC	Oman	800	thd tonnes/a	2020
Zapsibneftekhim	Russia	1,500	thd tonnes/a	2020
Shenhong Refining & Chemical	China	1,000	thd tonnes/a	2020
PTT Global Chemical	Thailand	500	thd tonnes/a	2020
Incremental capacity in 2020		**3,800**	thd tonnes/a	
Incremental capacity during 2017~2020		**21,384**	thd tonnes/a	

Source: ICIS, CICC Research

Earnings forecasts and valuation

Earnings forecasts

We expect SEG to post 2017, 2018 and 2019 EPS (before one-off items) of Rmb0.46, Rmb0.65 and Rmb0.74, for a CAGR of 25%. Despite a recent negative earnings alert for 2017—which we attribute mainly to one-off losses on currency exchange and asset impairment totaling around Rmb0.8bn after tax—we believe SEG's recurrent earnings still rose approximately 25% to Rmb2.1bn. We estimate the firm's net profit for 2017 at a record-low Rmb1.2bn (or Rmb0.27/share). Meanwhile, our 2018 and 2019 forecasts are a respective 13% and 9% above consensus projections.

Figure 24: Order forecasts

Rmb bn	2015A	2016A	2017E	2018E	2019E
Engineering, consulting and licensing					
Backlog at year-beginning	6.5	6.9	7.0	7.9	8.4
New orders	3.0	2.7	4.0	4.2	4.5
Order completed	-2.6	-2.6	-3.1	-3.8	-4.1
Backlog at year-end	6.9	7.0	7.9	8.4	8.7
Revenue	2.6	2.6	3.1	3.8	4.1
Revenue/(Backlog at year-beg. + New orders)	27%	27%	28%	31%	32%
EPC contracting					
Backlog at year-beginning	82.1	78.7	68.9	72.5	81.7
New orders	35.5	10.9	24.0	35.0	33.0
Order completed	-39.0	-20.6	-20.4	-25.8	-28.1
Backlog at year-end	78.7	68.9	72.5	81.7	86.6
Revenue	27.8	20.6	20.4	25.8	28.1
Revenue/(Backlog at year-beg. + New orders)	24%	23%	22%	24%	25%
Construction					
Backlog at year-beginning	15.2	14.3	12.1	11.6	14.2
New orders	14.0	13.8	11.0	18.0	17.0
Order completed	-14.9	-16.0	-11.6	-15.4	-16.2
Backlog at year-end	14.3	12.1	11.6	14.2	15.0
Revenue	14.9	16.0	11.6	15.4	16.2
Revenue/(Backlog at year-beg. + New orders)	51%	57%	50%	52%	52%
Equipment manufacturing					
Backlog at year-beginning	0.1	0.1	0.2	0.6	0.5
New orders	0.1	0.2	1.0	0.5	0.5
Order completed	-0.1	-0.2	-0.6	-0.5	-0.5
Backlog at year-end	0.1	0.2	0.6	0.5	0.5
Revenue	0.1	0.2	0.6	0.5	0.5
Revenue/(Backlog at year-beg. + New orders)	51%	51%	50%	51%	51%
Total					
Backlog at year-beginning	103.9	100.0	88.2	92.5	104.8
New orders	**52.7**	**27.6**	**40.0**	**57.7**	**55.0**
Order completed	-56.6	-39.4	-35.7	-45.5	-49.0
Backlog at year-end	**100.0**	**88.2**	**92.5**	**104.8**	**110.8**
Revenue	**45.5**	**39.4**	**35.7**	**45.5**	**49.0**
Revenue/(Backlog at year-beg. + New orders)	29%	31%	28%	30%	31%

Source: ICIS, CICC Research

Figure 25: Financial forecasts

Rmb mn	2016A	2017E	2018E	2019E
Income statement				
Revenue	**39,375**	**35,651**	**45,467**	**48,953**
Cost of sales	(35,085)	(31,018)	(39,165)	(41,963)
Gross profit	**4,291**	**4,633**	**6,302**	**6,989**
Selling expenses	(107)	(125)	(127)	(127)
General and administrative expenses	(1,160)	(1,248)	(1,591)	(1,713)
Research and development costs	(1,113)	(1,034)	(1,319)	(1,420)
Other income and expenses	24	-	-	-
Operating profit	**1,935**	**2,226**	**3,264**	**3,729**
Net finance costs	419	496	567	614
Share of profit from JV & associates	16	16	16	16
Profit before income tax	**2,369**	**2,738**	**3,847**	**4,359**
Income tax	(706)	(684)	(962)	(1,090)
Net income	1,663	2,053	2,885	3,269
Minority interest	0	(0)	(0)	(0)
NPAT	**1,663**	**2,053**	**2,885**	**3,269**
EBITDA	**2,658**	**2,975**	**4,048**	**4,548**
Balance sheet				
Cash and bank balances	11,862	13,562	14,576	18,659
Deposits and other financial assets	16	16	16	16
Trade and other receivables	9,990	8,595	10,962	10,729
Inventories	1,197	1,020	1,288	1,380
Other current assets	27,908	27,989	32,679	33,097
Total current assets	**50,972**	**51,183**	**59,520**	**63,881**
Fixed assets	3,975	3,775	3,642	3,523
Intangible assets	2,951	2,821	2,691	2,561
Interest in JV & associates	142	158	174	190
Other non-current assets	778	778	778	778
Total non-current assets	**7,846**	**7,533**	**7,286**	**7,053**
Total assets	**58,818**	**58,716**	**66,806**	**70,934**
Short-term borrowings	-	-	-	-
Trade and other payables	14,217	13,597	17,168	18,395
Other current liabilities	16,500	15,628	18,084	18,927
Total current liabilities	**30,717**	**29,226**	**35,252**	**37,322**
Long-term borrowings	-	-	-	-
Other non-current liabilities	2,899	2,899	2,899	2,899
Total non-current liabilities	**2,899**	**2,899**	**2,899**	**2,899**
Total liabilities	**33,616**	**32,125**	**38,151**	**40,221**
Shareholders equity	25,202	26,591	28,655	30,713
Total liabilities & equity	**58,818**	**58,716**	**66,806**	**70,934**
Cash flow statement				
Profit before tax	2,369	2,738	3,847	4,359
Depreciation & amortization	723	749	783	819
Working capital inflow / (outflow)	2,377	1,898	703	1,792
Others	(947)	(1,223)	(1,556)	(1,703)
Cash flow from operating	**4,522**	**4,162**	**3,777**	**5,267**
Capital expenditure	(580)	(470)	(570)	(620)
Others	(2,784)	(1,412)	(1,456)	563
Cash flow from investing	**(3,363)**	**(1,882)**	**(2,026)**	**(57)**
Issuance of new shares	-	-	-	-
Bank and financial institute loans	-	-	-	-
Dividend and interest paid	(1,131)	(664)	(821)	(1,212)
Others	-	84	84	84
Cash flow from financing	**(1,131)**	**(580)**	**(737)**	**(1,127)**
Foreign exchange gain (loss)	428	-	-	-
Net changes in cash	**456**	**1,700**	**1,014**	**4,083**
Free cash flow	**3,943**	**3,692**	**3,207**	**4,647**

Financial ratios	2016A	2017E	2018E	2019E
Growth ability				
Revenue	-13%	-9%	28%	8%
Gross profit	-30%	8%	36%	11%
Operating profit	-50%	15%	47%	14%
EBITDA	-40%	12%	36%	12%
Net profit	-50%	23%	41%	13%
Profitability				
Gross margin	11%	13%	14%	14%
Operating margin	5%	6%	7%	8%
EBITDA margin	7%	8%	9%	9%
Net margin	4%	6%	6%	7%
Liquidity				
Current ratio	1.7	1.8	1.7	1.7
Quick ratio	1.6	1.7	1.7	1.7
Cash ratio	0.4	0.5	0.4	0.5
Debt / asset	57%	55%	57%	57%
Return				
RoA	3%	3%	5%	5%
RoE	7%	8%	10%	11%

Segment data (Rmb mn)	2016A	2017E	2018E	2019E
Engineering, consulting and licensing				
Revenue	2,612	3,074	3,752	4,112
Gross margin	34.6%	36.0%	39.0%	39.5%
EPC contracting				
Revenue	20,641	20,445	25,797	28,099
Gross margin	12.2%	12.5%	13.5%	14.0%
Construction				
Revenue	15,964	11,555	15,369	16,217
Gross margin	5.2%	8.0%	8.5%	8.5%
Equipment manufacturing				
Revenue	159	577	549	524
Gross margin	18.7%	8.0%	9.0%	10.0%

Source: Company data, CICC Research

Valuation

DCF+DDM valuation. We value SEG using a DCF model for free cash flows over 2018–2028 assuming a 9.6% WACC and deriving a present value of its EV of Rmb18bn. For terminal value, we adopt a DDM model assuming an 11.1% cost of equity and 30% long-term dividend payout ratio, deriving a present value of terminal value of Rmb1.5bn. Summing the two, we arrive at a total EV of Rmb19.6bn and estimate SEG's equity value at Rmb35.4bn or HK$10.1/share, equivalent to 11x 2019e P/E and 4.3x 2019e EV/EBITDA.

We initiate overage of SEG with a BUY rating and target price of HK$9.7, equivalent to 4.0x 2019e EV/EBITDA and 10x 2019e P/E and offering 23% upside.

Figure 26: DCF+DDM valuation

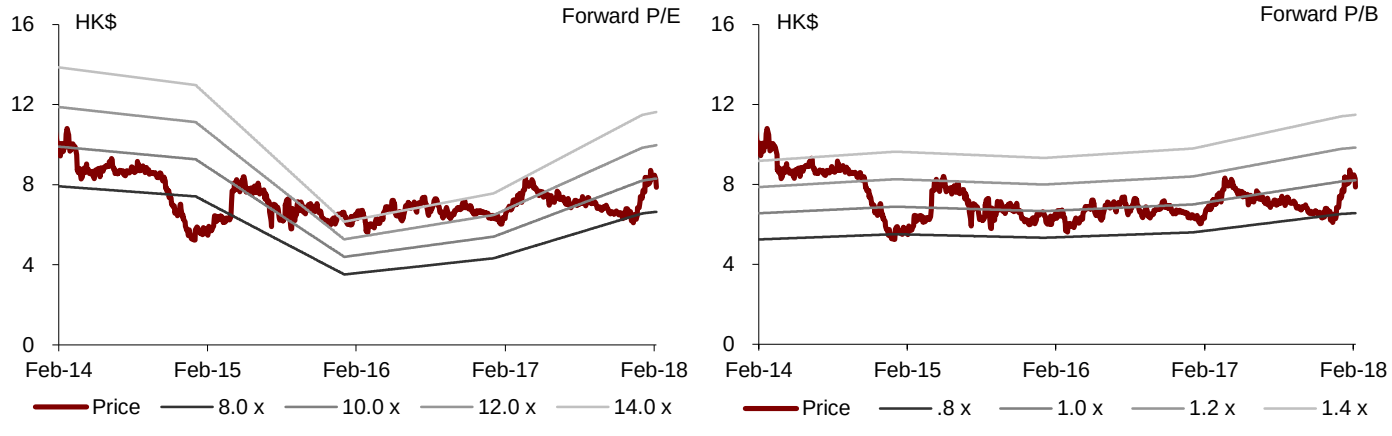
Rmb bn	2016A	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E
EBIT	1.93	2.23	3.26	3.73	4.64	4.75	4.83	4.11	3.49	2.97	2.52	2.14	1.82
After tax EBIT	1.36	1.67	2.45	2.80	3.48	3.56	3.63	3.08	2.62	2.23	1.89	1.61	1.37
+ DD&A	0.58	0.60	0.63	0.67	0.71	0.74	0.77	-	-	-	-	-	-
- Working capital changes	-4.23	-1.90	-0.70	-1.79	-0.05	0.00	-0.04	-	-	-	-	-	-
- Capex	0.58	0.47	0.57	0.62	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52
Free cash flow	5.58	3.70	3.21	4.64	3.72	3.78	3.91	2.56	2.10	1.71	1.37	1.09	0.85
NPAT	1.6	2.1	2.9	3.3	4.0	4.1	4.2	3.5	3.0	2.6	2.2	1.9	1.6
Dividend	0.7	0.8	1.2	1.5	1.8	1.8	1.9	1.1	0.9	0.8	0.7	0.6	0.5
Dividend payout ratio	41%	40%	42%	45%	45%	45%	45%	30%	30%	30%	30%	30%	30%

PV of FCF over 2019~2028	**18.1**
PV of terminal value	**1.5**
EV	**19.6**
- Net debt	(15.8)
- MI	0.0
Equity value (Rmb mn)	**35.4**
Equity value (HK$ mn)	**44.6**
Equity value per share (HK$)	**10.1**

WACC calculation	
Risk free rate	2.8%
Risk premium	5.5%
Beta	1.50
Cost of equity	**11.1%**
Pre-tax cost of debt	5.0%
Income tax rate	25.0%
Cost of debt	**3.8%**
Debt weighting target	20.0%
WACC	**9.6%**

Source: Company data, CICC Research

Figure 27: Forward P/E and P/B



Source: Company data, Bloomberg, CICC Research

Figure 28: Valuation of comparable companies

	Bloomberg code	Curr.	Price 2018/2/6	Mkt. cap (US$ bn)	P/E (x)				P/B (x)				EV/EBITDA (x)				Div. yield				ROE			
					16A	17E	18E	19E	16A	17E	18E	19E	16A	17E	18E	19E	16A	17E	18E	19E	16A	17E	18E	19E
A-Share																								
Zhongyou Engineering	600339 CH	RMB	4.36	3.9	15.6	n.m.	n.m.	n.m.	1.2	n.m.	n.m.	n.m.	3.2	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	6%	n.m.	n.m.	n.m.
CNCE	601117 CH	RMB	7.19	5.6	20.0	17.1	13.0	10.9	1.3	1.2	1.1	1.1	9.5	8.6	5.3	4.7	1.5%	1.5%	1.9%	2.2%	7%	7%	9%	10%
East China Engineering	002140 CH	RMB	8.07	0.6	44.8	n.m.	n.m.	n.m.	1.8	n.m.	n.m.	n.m.	27.9	n.m.	n.m.	n.m.	0.6%	n.m.	n.m.	n.m.	4%	n.m.	n.m.	n.m.
Average					*32.4*	*17.1*	*13.0*	*10.9*	*1.5*	*1.2*	*1.1*	*1.1*	*18.7*	*8.6*	*5.3*	*4.7*	*1.1%*	*1.5%*	*1.9%*	*2.2%*	*5%*	*7%*	*9%*	*10%*
H-share																								
SEG	2386 HK	HKD	7.87	*4.5*	18.8	14.5	9.6	8.4	1.2	1.1	1.0	0.9	7.3	5.5	3.2	2.0	2.1%	2.8%	4.4%	5.3%	7%	8%	10%	11%
Wison Engineering	2236 HK	HKD	1.62	0.8	130.6	n.m.	n.m.	n.m.	2.9	n.m.	n.m.	n.m.	27.9	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	2%	n.m.	n.m.	n.m.
China Railway Group	390 HK	HKD	5.81	28.8	9.6	7.4	6.6	5.9	0.9	0.7	0.7	0.6	11.7	6.8	9.0	8.3	1.8%	2.2%	2.5%	2.7%	10%	10%	11%	11%
China Railway Construction	1186 HK	HKD	8.95	24.0	7.4	6.3	5.7	5.1	0.8	0.7	0.6	0.6	9.1	5.1	7.3	6.7	2.1%	2.5%	2.8%	3.1%	12%	11%	11%	12%
China Communications Const	1800 HK	HKD	8.82	32.6	7.1	6.3	5.6	4.9	0.8	0.7	0.6	0.6	12.0	5.9	10.0	9.1	2.6%	3.1%	3.5%	4.0%	11%	11%	11%	12%
Metallurgical Corp of China	1618 HK	HKD	2.37	13.6	8.1	7.1	5.7	4.9	0.7	0.6	0.5	0.5	17.3	7.5	12.6	11.4	3.0%	3.3%	4.2%	5.0%	8%	9%	10%	11%
Average					*30.1*	*8.3*	*6.6*	*5.8*	*1.2*	*0.8*	*0.7*	*0.6*	*13.8*	*7.1*	*8.4*	*7.6*	*2.3%*	*2.8%*	*3.5%*	*4.0%*	*8%*	*10%*	*11%*	*11%*
Asian comparables																								
Ctci Corp	9933 TT	TWD	44	1.1	15.0	12.0	13.2	11.3	2.0	1.9	1.9	1.8	6.4	8.6	6.7	5.7	5.9%	6.7%	7.3%	8.2%	13%	15%	15%	17%
Chiyoda Corp	6366 JT	JPY	959	2.3	73.6	n.m.	40.3	46.5	1.2	1.5	1.6	1.5	6.9	12.7	-23.3	11.4	1.0%	0.6%	0.6%	0.7%	2%	-20%	3%	4%
JGC Corp	1963 JT	JPY	2,182	5.2	12.9	n.m.	23.1	19.2	1.3	1.4	1.4	1.3	7.2	44.7	11.5	10.1	1.9%	1.4%	1.2%	1.4%	11%	-1%	6%	7%
Samsung Engineering	028050 KS	KRW	16,450	3.0	109.7	162.0	19.7	12.7	3.1	3.0	2.6	2.2	26.5	20.8	13.1	9.5	n.m.	n.m.	n.m.	0.6%	n.m.	2%	13%	17%
GS Engineering	006360 KS	KRW	31,950	2.1	n.m.	n.m.	8.8	7.0	0.7	0.7	0.7	0.6	33.0	6.0	6.2	5.5	n.m.	n.m.	0.7%	0.5%	-1%	0%	8%	9%
Hyundai Engineering	000720 KS	KRW	43,250	4.4	8.4	11.6	9.0	8.0	0.8	0.7	0.7	0.6	4.0	3.7	4.3	4.0	1.2%	1.2%	1.3%	1.3%	9%	7%	8%	8%
Larsen & Tubro Ltd	LT IN	INR	1,353	29.5	44.6	35.9	27.1	23.6	4.3	3.9	3.4	3.0	26.5	15.9	21.1	17.8	0.9%	0.9%	1.2%	1.4%	10%	11%	13%	14%
Average					*44.0*	*55.4*	*20.2*	*18.3*	*1.9*	*1.9*	*1.7*	*1.6*	*15.8*	*16.1*	*5.7*	*9.1*	*2.2%*	*2%*	*2%*	*2%*	*7%*	*2%*	*10%*	*11%*
US/European comparables																								
Fluor	FLR US	USD	56.95	8.0	28.2	36.7	22.4	18.7	2.5	2.3	2.1	1.9	9.2	13.1	9.2	8.1	1.5%	1.5%	1.5%	1.5%	9%	7%	11%	9%
Mcdermott Intl Inc	MDR US	USD	8.12	2.3	58.0	14.3	20.0	15.7	1.3	1.3	1.2	1.1	10.0	5.8	7.3	6.3	n.m.	n.m.	n.m.	n.m.	2%	9%	6%	7%
Saipem	SPM IM	EUR	3.52	2.9	n.m.	25.1	25.3	20.2	0.7	0.7	0.7	0.7	-6.2	3.5	5.8	5.5	n.m.	n.m.	0.2%	0.8%	-50%	2%	3%	4%
Technip	TEC FP	USD	31.88	14.8	30.1	21.1	24.5	20.5	1.1	1.2	1.2	1.1	12.9	7.9	8.3	7.7	n.m.	0.9%	1.6%	1.7%	6%	6%	5%	6%
Petrofac	PFC LN	GBP	4.67	1.2	n.m.	6.7	8.2	9.9	2.0	2.0	1.8	1.6	9.0	2.3	5.2	5.8	10.1%	5.6%	5.5%	5.1%	0%	28%	18%	17%
KBR	KBR US	USD	18.77	2.6	n.m.	12.7	13.8	12.7	3.5	2.9	2.5	2.2	35.9	7.7	8.0	7.5	1.7%	1.7%	1.7%	1.7%	-7%	24%	19%	17%
Average					*38.8*	*19.5*	*19.0*	*16.3*	*1.9*	*1.7*	*1.6*	*1.4*	*11.8*	*6.7*	*7.3*	*6.8*	*4.4%*	*2.4%*	*2.1%*	*2.2%*	*-6%*	*13%*	*10%*	*10%*
Global Summary																								
Highest					130.6	162.0	40.3	46.5	4.3	3.9	3.4	3.0	35.9	44.7	21.1	17.8	*10.1%*	*6.7%*	*7.3%*	*8.2%*	*13%*	*28%*	*19%*	*17%*
Lowest					7.1	6.3	5.6	4.9	0.7	0.6	0.5	0.5	-6.2	2.3	-23.3	4.0	*0.6%*	*0.6%*	*0.2%*	*0.5%*	*-50%*	*-20%*	*3%*	*4%*
Average					38.0	25.5	16.2	14.3	1.7	1.5	1.4	1.3	14.8	10.4	7.1	8.1	*2.6%*	*2.4%*	*2.4%*	*2.5%*	*3%*	*8%*	*10%*	*11%*

Source: Company data, Bloomberg, CICC Research

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