# Strong outlook for Sino Hua-An

| BY CHOONG KHUAT HOCK |

Sino Hua-An (SHA), with operations based in Shandong province, China, is the first red chip counter to be listed on Bursa Malaysia. The company processes coking coal into metallurgical coke, which is an important raw material used in steel production. By-products from the process are tar, crude benzene, ammonium sulphate and coal gas.

SHA recently expanded its production capacity from 1.2 million tonnes to 1.8 million tonnes per annum and will be looking to operate at full capacity by end-2009.

SHA's location in Shandong province places it strategically in close proximity to major steel players as well as coal reserves in China. The company has a 10-year railway transport contract to transport its raw materials and products at a cheaper rate. It also has a 30-year electricity supply contract to ensure that it has a continuous and reliable source of power. Given that China may face infrastructure constraints and electricity shortages in the future, having such long-term contracts in place may help the company avoid disruptions to production. This is especially important for coke manufacturing, where it can take a month just to get the oven up to the optimal temperature.

SHA's production is carried out with its proprietary blending formula and charging process. The coke produced is of a higher quality and fetches a premium pricing. The special coal blend allows SHA's coking process to achieve higher productivity in a shorter period of 20 to 22 hours than the industry average of 22.5 hours.

In fact, prior to the recent expansion, SHA was operating at 1.3 million tonnes per annum, above its rated capacity of 1.2 million tonnes per annum. A rough breakdown of the products from the coking process is shown in Figure 1. The values are not absolute and may change, depending on the blend of coal used. In 2007, SHA derived 75.3% of its revenue from the sale of coke, 7.7% from coal gas and 6.7% from tar.

In the near future, SHA's main focus will be on improving the efficiency of its new plant. Beyond 2009, the company is looking at merger and acquisition activities across the value chain to fuel growth. Undertaking a meaningful acquisition should not be difficult since the company currently has no gearing and has a cash pile of RMB130 million (RM65.8 million). It may consider purchasing coal mines to secure supplies for its production, venture downstream into steel production or invest in plants that will add value to its by-products.

Chinese demand for steel is expected to slow down following the end of the Beijing Olympics. Infrastructure projects were rushed through in order to be completed before the Olympics and this led to an artificial rise in steel prices. Now that the games are over, demand will be lower but is expected to remain firm. Over the next few years, demand for steel will be driven by the implementation of projects like the Shanghai Expo, Three Gorges Dam and the rebuilding of the earthquake-hit Sichuan province. Plans to link up 12,000km of high-speed railway in the country will require spending hundreds of billions of RMB on steel alone. The government also plans to spend on infrastructure to develop the

CONTINUES ON PAGE 51

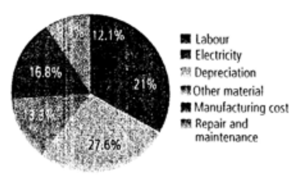
FIGURE 1

### Rough breakdown of products from coke manufacturing process

1.4 t Coal
1 t Coke
0.05 t Tar
0.0135 t Crude bBenzene
0.0130 t Ammonium sulphate
225 m3 Coal gas

FIGURE 2

### Processing cost breakdown for 2007




*(cost = RM65.9 million excluding coal purchase)*

FIGURE 3

### Company data and financials

| | 2006 | 2007 | 2008E |
|---|---|---|---|
| Sales (RM mil) | 730.7 | 850.1 | 1399.8 |
| Operating income (RM mil) | 119.3 | 152.0 | 172.0 |
| Net income (RM mil) | 115.0 | 127.5 | 136.7 |
| EPS (RM) | 0.575 | 0.121 | 0.168 |
| PER (x) | 0.6 | 2.8 | 2.0 |
| DPS (RM) | n/a | 0.023 | 0.026 |
| Dividend yield (%) | n/a | 6.5 | 7.4 |
| ROE (%) | n/a | 26.0 | 18.7 |

*Source: Bloomberg I/B/E/S*

# Company provides a cheap entry into coal sector

FROM PAGE 40

south- western part of China as part of its efforts to reduce the socio-economic disparity in the rural areas.

With economies around the world facing a slowdown, China, whose exports make up 20% of gross domestic product, will no doubt feel the impact as well. However, we believe that it is still too early to turn bearish on the Chinese economy. If signs of weakening do emerge, we are expecting the Chinese authorities to take appropriate measures to sustain growth. The stock market and property prices appeared to be in a bubble phase but have since corrected significantly from its peaks. Headline inflation was a major concern until the recent crash in commodity prices. Monetary policy has been tight and the reserve requirement ratios have been hiked up aggressively. This leaves the authorities with plenty of leeway to be loose on monetary policy and indeed interest rates in China have recently been cut following a decline in the inflation rate.

Despite spending on major infrastructure projects, the government maintains a modest budget surplus. It could easily resort to fiscal stimulus and pump-prime the economy by speeding up infrastructure development in rural areas. Such fiscal spending will boost steel demand and benefit SHA.

SHA recorded a gross processing margin (excluding by-product sales) of RMB269 per tonne in 2007 (up from RMB100 per tonne in 2006) and looks set to achieve better margins in 1H2008 on the back of capacity constraints in the conversion of coal to coke. Processing cost (excluding coal purchase) in 2007 is estimated at RMB120 per tonne. However, margins may be squeezed if additional coke conversion capacity comes on stream at a time when steel demand moderates.

Trading at a PER of less than three times, SHA provides a cheap entry into the coal sector. Assuming an exchange rate of RMB2 to 1RM, SHA's market cap currently stands at RMB840 million. After stripping out its cash of RMB130 million, the enterprise value is estimated at RMB710 million. Thus, SHA's production capacity is valued at about RMB400 per tonne of coke, which is below the construction cost of new coke capacity at over RMB600 per tonne. SHA is trading below book value, with a price to book of 0.53. Its dividend yield is also attractive at 7.6% for FY2008. Nevertheless, SHA operates in a cyclical industry and may face a squeeze in margins post-Olympics, which could see a slowdown in steel and hence coke demand. Its low rating does not augur well for Bursa as a destination for the listing of foreign companies. Larger Chinese companies prefer a Hong Kong listing, while second-tier Chinese companies often consider a Singapore listing. More incentives and active promotion are required to attract foreign companies to list in Malaysia. E

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