

Analyst: Kelvin Li

CHINA SHENHUA ENERGY (中國神華能源)

Sector	: Energy
HKSE code	: 1088
Market price	: HK\$32.95 (17/03/2008)
HSI	: 21,084.61 (17/03/2008)
H shares issued	: 3,398.6 million
H-share mkt. cap.	: HK\$111,983.2 million
52 weeks Hi/ Lo	: HK\$57.95/ HK\$18.80

Chairman	:	Chen Biting
Director	:	Ling Wen

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2007
Final Results Highlights

	<u>FY2007</u>	<u>FY2006</u>	<u>Change</u>
	RMB million	RMB million	
• Turnover	82,107	65,186	+26.0%
• Total cost of revenue	(43,773)	(33,055)	+32.4%
• Total operating expenses	(49,610)	(37,695)	+31.6%
• Operating profit	32,497		+18.2%
		27,491	
• Profit attributable to shareholders	20,581	17,644	+16.6%
	<u>RMB</u>	<u>RMB</u>	
• EPS – basic	1.110	0.975	+13.8%
• Special interim DPS*	0.92863	-	N/A
• Special final DPS*	0.31760	-	N/A
• Final DPS	0.18000	0.34000	-47.1%
• Total DPS	1.42623	0.34000	+319.5%

Remark: (*) A special interim dividend of RMB0.92863 and a special final dividend of RMB0.3176 payable to domestic state-owned share and H-share holders were declared in October 2007 and March 2008, respectively, to distribute the Company's profit to the parent company, the Shenhua Group, and H-shareholders as part of the arrangement of the A-share issue last year.

- China Shenhua Energy reported a 16.6% y-o-y rise in net profit to RMB20.6 billion, worse than market expectation of RMB22.1 billion. The Group's earnings was driven by strong sales volume but dragged by higher costs and weaker-than-expected product prices.
- Driven by strong revenue growth from both the coal (+21.2%) and the power (+40.3%) segments, turnover was up 26% to RMB82.1 billion. Total operating expenses increased 31.6% to RMB49.6 billion due to a 54.6% y-o-y rise in cost of 3rd party coal purchase as well as rising material, fuel & power costs and personnel expenses. As a result, operating profit grew just 18.2% to RMB32.5 billion, while the operating margin slipped 2.6 pp to 39.6% in FY07 from 42.1% a year earlier.
- EPS grew 13.8% y-o-y to RMB1.11. A final dividend of RMB0.18 was declared. Pursuant to the domestic A-share issue, China Shenhua also proposed a final special dividend of RMB0.3176, payable to H-shareholders and its parent. Along with an interim special dividend declared in Oct 07, a total special DPS of RMB1.42623 was proposed for FY07.

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- As of 31/12/2007, China Shenhua had total debt of RMB59.9 billion (31/12/2006: RMB58.8 billion). With a cash on hand of RMB53.4 billion (31/12/2006: RMB15.7 billion) following the A-share issue, China Shenhua's net debt-to-shareholders' equity ratio was reduced substantially to 5.0% at end of FY07 from 61.7% as of 31/12/2006.

Business Highlights

- Turnover breakdown by business segments (excluding inter-segment sales):

	FY2007		FY2006		CHG
	RMB million	%	RMB million	%	
Coal	55,741	67.9%	45,948	70.5%	+21.3%
Power	23,922	29.1%	17,056	26.2%	+40.3%
Other	2,444	3.0%	2,182	3.3%	+12.0%
Total	82,107	100.0%	65,186	100.0%	+26.0%

- Operating profit analysis by segments:

	<u>Operating profit</u>					<u>Operating margin</u>		
	FY2007		FY2006		CHG	FY07	FY06	CHG
	RMB million	%	RMB million	%				
Coal	18,096	55.7%	16,610	60.4%	+8.9%	27.4%	31.2%	-3.8 ppts
Railway	8,581	26.4%	6,537	23.8%	+31.3%	52.9%	50.4%	+2.5 ppts
Port	376	1.2%	193	0.7%	+94.8%	19.0%	12.3%	+6.7 ppts
Power	5,875	18.1%	4,496	16.4%	+30.7%	24.1%	25.9%	-1.8 ppts
Other	(431)	(1.3%)	(345)	(1.3%)	+24.9%	-	-	N/A
Total	32,497	100.0%	27,491	100.0%	+18.2%	39.6%	42.2%	-2.6 ppts

- External **coal** sales rose 21.3% y-o-y to RMB55.7 billion, led by a 20.0% y-o-y rise in external sales volume to 178.5 million tonnes in FY07. Sales to the Group's power segment increased 36.6% y-o-y to 30.6 million tonnes. Altogether, the Group's total coal sales volume grew 22.2% y-o-y to 209.1 million tonnes in FY07. Of the total coal sales, 185.1 million tonnes was sold in domestic market and 24.0 million tonnes was for exports, up 25.7% and 0.4% y-o-y, respectively. As such, exports dropped to 11.5% of the Group's total coal sales volume from 14.0% in FY06. The average realised sales price was RMB312.9 per tonne, up only 1.6% y-o-y, well below market expectation of a double-digit rise in selling prices. The Group's coal segment contributed an operating profit of RMB18.1 billion in FY07, up a sluggish 8.9% y-o-y, as rising costs ate into the segment's profit margin. Owing to higher materials and power costs, the segment's operating margin fell to 27.4% in FY07 from 31.2% in FY06.
- The Group's **power** business exhibited stronger growth momentum in 2007. The Group operated 13 coal-fired power plants with total installed capacity of 15,091 MW, up nearly 20% y-o-y, while the Group entitled to an equity installed capacity of 9,284 MW, up 23.6% y-o-y. Total power output dispatch surged a robust 37.8% y-o-y to 74.3 billion kWh, boosting the segment's operating revenue by 40.3% to RMB23.9 billion. The average power tariff was up 2.9% y-o-y to RMB321/MWh, while the segment's unit coal cost was RMB431/tonne, up 11.7% y-o-y. As a result, the power segment reported 30.7% y-o-y rise in operating profit to RMB5.9 billion, but saw its operating margin narrowed to 24.1% from 25.9% in FY06.
- The Group began separate reporting of its **railway** and **port** operations in the FY07 full-year results. The railway segment reported a 25.1% y-o-y rise in total revenue to RMB16.2 billion in FY07, of which RMB14.8 billion was for internal transportation, up 26.1% y-o-y. Operating profit from the Group's railway operations amounted to RMB8.6 billion, up 31.3% y-o-y and accounting for 26.4% of the Group's total (FY06: 23.8%). For the port segment, revenue grew 26.3% y-o-y to RMB2.0 billion, thanks to a 10.7% rise in seaborne coal sales. Its operating profit totalled RMB376 million, up 94.8% y-o-y and accounting for 1.2% (FY06: 0.7%) of the Group's total.

Outlook & Prospects

- **A-share issue completed** China Shenhua issued 1.8 billion new A shares in September 2007 at RMB36.99 each, raising a net proceeds of RMB66.0 billion. The proceeds would be used for funding the construction of Halagou Mine, Herwusu Mine, upgrade of existing mines like Shendong Mines and Wanli Mines. It will also be used for acquisition of assets from its parent company and overseas expansion.
- **Operating costs surprised on the upside** The Group's FY07 earnings fell below market expectations, as rising costs depressed profit margins. Profit margin is expected to stay under pressure in 2008, as global energy prices stand at high levels pushing up the Group's fuel & power costs. Rising salary and a potential hike in resource tax in the Mainland are also expected to push up the Group's operating costs in the future.
- **Setting a higher output target** During the release of the 2007 interim results, China Shenhua has outlined its plan to raise its output of raw coal by an average 15 million tonnes p.a. in 2006-2010, which would take its annual commercial coal output to 200 million tonnes by 2010. In FY07, the actual commercial coal output amounted to 158 million tonnes, higher than the original target of 152 million tonnes. Accordingly, the Group also raises its 2008 coal output target to 177 million tonnes, up nearly 3% from the original estimate of 172 million tonnes and up 12% from 2007.
- **Expanding power business** Echoing Beijing's call to strengthen the country's power generation infrastructure, China Shenhua has earmarked a capital expenditure of RMB16.86 billion for the power segment, up 57.5% from a year earlier and accounting for 42.4% (FY07: 35.6%) of the total capex in 2008, which is even higher than the capex of RMB13.84 billion budgeted for the coal segment. According to the original plan, China Shenhua has budgeted for a capex of RMB41.4 billion for the power segment in 2007-2009, and expects to grow the total installed capacity to 20,000 MW by 2010 from 15,091 MW as at the end of 2007.
- **High capex budget but lower portion to coal operations** China Shenhua has budgeted a total capex of RMB39.78 billion in 2008, up 32% from FY07. Only 34.8% of the 2008 capex would be allocated to the coal segment, down from 52.7% in FY07. The Group said it would stick to its three-way M&A strategy, i.e. step-by-step purchase of quality assets from parent, acquiring coal mines from local governments and overseas acquisitions (mainly in Republic of Mongolia, Indonesia and Australia).
- **FY2007 results disappointing but better outlook in FY08** Rising operating costs in China Shenhua's 2007 results has drawn some investor concerns over its profit margin outlook. Nonetheless, expected higher coal contract prices in 2008 should help offset the cost pressure and maintain a healthy profit margin. Shenhua's share prices have fallen by more than 43% from its record highs set in November 2007, and investment value starts emerging. Trading at 20x FY08E P/E, valuations turned less demanding given its improving coal price outlook, and we accordingly give a "Hold" recommendation on the counter.

Recommendation: HOLD

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