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HONG KONG RESEARCH

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Analyst: Kelvin Li

## Main Board Listing – Research

宏華集團有限公司

Honghua Group Limited [Stock Code: 0196]

**Joint Global Coordinators, Joint Bookrunners,  
Joint Sponsors and Joint Lead Managers**

: Credit Suisse

Morgan Stanley

**Sector** : Capital goods

**Business** : Manufacture of land drilling rigs and rig parts and components

<p><b>Total share offer:</b> <u>833,360,000</u> shares (25% of the enlarged share capital)</p> <p><b>Public Offer:</b> 83,336,000 shares (10%)</p> <p><b>Placing:</b> 750,024,000 shares (90%)</p> <p><b>Greenshoe:</b> 125,000,000 shares</p>	<p><b><u>Business of Honghua Group</u></b></p> <p>The Group is a manufacturer of land drilling rigs and rig parts and components. It also provides drilling-related training and after-sales support services to its customers.</p> <p>The Group is mainly engaged in the design, manufacture and sale of drilling rigs for use in the exploration and extraction of oil and gas from reservoirs located in a variety of geological formations and environments and at considerable depths. According to industry survey, the Group is the second largest land rig manufacturer in the world and the largest in the Mainland in terms of revenue and production volume in 2006. Besides, the Group also manufactures rig parts and components for the use in the production of its own rigs as well as external sales.</p> <p>The Group mainly sells its products in the overseas market like North America, the Middle East and Africa.</p>
<p><b>Price:</b> HK\$3.16 – HK\$4.50 per share</p> <p><b>Market Cap:</b> HK\$10.5 billion–HK\$15.0 billion</p> <p><b>Pro forma FY2007E PER:</b> 18.15x to 25.85x</p> <p><b>Adjusted NTA per share:</b> HK\$0.92 - HK\$1.24</p> <p><b>Staffing:</b> 2,828 (as of 31<sup>st</sup> August 2007)</p>	
<p><b>HK Public Offer period:</b> 25<sup>th</sup> February 2008 – 28<sup>th</sup> February 2008 noon</p> <p><b>Receiving bank:</b> Bank of Communications ICBC (Asia)</p> <p><b>Share registrar:</b> Computershare Hong Kong Investor Services Limited</p> <p><b>Listing date:</b> 7<sup>th</sup> March 2008</p>	

### Shareholders after Listing (Assuming the over-allotment option is not exercised)

Ally Giant – a company indirectly owned by the Group's executive directors, senior management and their family members. The ZYL Family Trust, established by Chairman Zhang Mi, holds an indirect stake of 36% in Ally Giant	48.53%
Nabors International – an international contractor and a client of the Group	13.50%
China Ocean Oilfields Services (Hong Kong) Limited	5.22%
Carlyle Funds	5.01%
Development Partners Fund	1.59%
Vincera Group	0.80%
IP Cathay One, L.P.	0.34%
Public Investors	25.00%
	<u>100.00%</u>

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### Use of Proceeds

Net proceeds from the offer are estimated to be HK\$2,972 million (Assuming an offer price of HK\$3.83, being the mid-point of the indicative offer price range, and the over-allotment option is not exercised)

	HK\$ million
For the construction of an offshore equipment manufacturing base in the eastern coastal area of China, to produce jack-up rigs and fixed rigs as well as large structures.	1,783 (60% of the total)
For increasing production capacity and for the development of new land rig equipment and rig parts and components.	357 (12% of the total)
For acquisition, establishing joint ventures and strategic alliances with international partners.	594 (20% of the total)
For working capital	Remaining balance

### Financial Highlights

	Year ended 31 <sup>st</sup> Dec			8 months ended	
	2004	2005	2006	31 <sup>st</sup> Aug 2006	31 <sup>st</sup> Aug 2007
	RMB '000	RMB '000	RMB '000	RMB '000	RMB '000
Revenue	539	502	2,336	843	1,519
Gross profit	99	109	778	244	500
Operating profit	54	47	590	166	305
<b>Profit attributable to shareholders</b>	<b>32</b>	<b>18</b>	<b>413</b>	<b>67</b>	<b>201</b>
Gross profit margin	18.40%	21.65%	33.30%	29.00%	32.89%
Operating profit margin	10.10%	9.40%	25.27%	19.72%	20.12%
Net profit margin	5.97%	3.68%	17.67%	7.90%	13.24%
	<b>31/12/2004</b>	<b>31/12/2005</b>	<b>31/12/2006</b>	<b>31/8/2006</b>	<b>31/8/2007</b>
Net debt/(cash) to Equity	16.31%	(346.37%)	10.65%	N/A	71.54%

### Strengths/Opportunities

- ✓ Demand for crude oil as well as orders to replace obsolete equipment are expected to boost global demand for new land rigs in coming years. New land rigs demand in China is expected to grow to 200 per year by 2012 from 140 in 2006, while that of Russia is seen growing rapidly from 40 in 2006 to 175 by 2012.
- ✓ The Group offers its clients a wide range of drilling rigs and related products at a low cost, which helps maintain its leading position in the world's drilling rig market.
- ✓ Raw material costs accounted for nearly 90% of the Group's cost of goods sold. Nonetheless, thanks to the Group's efforts in cost control and established relationship with its major suppliers, Honghua was able to maintain healthy profit margins over the last couple of years.
- ✓ The Group plans to boost its annual rigs production capacity by more than 70% to 150 rigs in 2008 from 86 rigs in 2006. Besides, it also plans to expand its annual mud pump production capacity to 500 by 2008 from 410 in 2006.

### Weaknesses/Threats

- × Demand for the group's product is affected by trends of oil and gas prices. A slowdown in the world economy and fluctuation in oil prices may lead to negative impact on the Group's business operations.
- × The Group relies on a limited number of customers.

**Recommendation: Trading Buy**

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