



Company Report

China Shenhua (1088 HK) – Buy China Coal & Consumable Fuels Industry 12-month target price: HK\$34.5

Key data

Share price (HK\$)	29.8
Target price (HK\$)	34.5
Upside potential (%)	15.8
52Wk H/L(HK\$)	38/24.5
Issued shares (mn)	19,889.6
- H Shares (mn)	3,398.6
- A Shares (mn)	16,491.0
Market cap	
- H Shares (HK\$mn)	101,278
- A Shares (Rmbmn)	364,781
3-mth ave daily turnover (HK\$ mn)	458.67
Auditors	KPMG
Major shareholder (%)	
Shenhua Group Corp Ltd	72.96

Source: Company & Bloomberg

Revenue composition in FY11 (%)

Coal	68.5
Power	28.3
Railway	1.3
Shipping	1.4
Port	0.1
Others	0.4

*Based on FY11 results

Source: Company

Share performance (%)

	Absolute	Relative*
1-mth	7.2	2.8
3-mth	7.4	0.8
6-mth	(16.8)	(9.0)

*Relative to Hang Seng Index

Source: Bloomberg

1 year price performance



Source: Bloomberg

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China's coal giant benefit from industrial reshape

China Shenhua, the coal market leader, will benefit most from: 1) recovering coal demand in light of economic recovery; 2) on-going industry reshaping to benefit large players; 3) good vertical consolidation opportunities. We initiate our coverage for China Shenhua with a “BUY” recommendation and set target price at HK\$ 34.5/share.

As the largest coal producer and consumer in the world, China is reshaping its coal market by encouraging mine consolidation and restricting the coal supply. More recourse is expected to be reallocated to large SOE players while S&M coal producers would be wiped out of market permanently.

China's heterogeneous economic development and unbalanced coal reserve distribution deteriorates coal transportation. We believe that Shenhua is in the best position to fill the regional coal shortage, given its strong logistic capacity in both railway and port transportation.

Slower growth expected in 1H12 and FY12, but with its growing power business, Shenhua would be relatively defensive among its peers. We estimate that coal business revenue will increase by only 10% in FY12 (dropped from 32.1% in FY11). But the power business still enjoy relatively high growth rate (24% FY12E vs 30.2% FY11).

We initiate our coverage for Shenhua with a “BUY” recommendation. Our TP is based on P/B and forward PER at 2.16x and 13.16x, respectively, with 15.8% upside potential.

Risk factors: 1) the influx of foreign coal cap the rebound momentum of domestic coal prices; 2) weak power consumption growth on slowed economic growth; 3) policy risk from government policy changes.

Performance and Valuation

FY ended Dec 31	FY09A	FY10A	FY11A	FY12E	FY13E
Turnover (Rmb mn)	121,312	157,662	208,197	237,392	272,070
Chg (%.yoy)	13.2	30.0	32.1	14.0	14.6
Net Income (Rmb mn)	31,706	38,834	45,677	42,398	48,439
Chg (%.yoy)	19.0	22.5	17.6	-7.2	14.2
EPS (Rmb)	1.594	1.952	2.296	2.132	2.435
Chg (%.yoy)	19.0	22.5	17.6	-7.2	14.2
BVPS (Rmb)	8.58	10.31	11.35	12.97	14.81
Chg (%.yoy)	15.8	20.2	10.1	14.3	14.2
P/E (x)	—	—	10.6	11.4	9.9
P/B (x)	—	—	2.1	1.9	1.6
Dividend yield (%)	—	—	3.7	3.4	3.9
ROAE (%)	19.9	20.7	21.2	17.53	17.53

Source: Company, Bloomberg, ABCI Securities estimates (assuming 1Rmb=1.23HKD)



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Industry Analysis

Our analysis of the coal industry in China has the following implications:

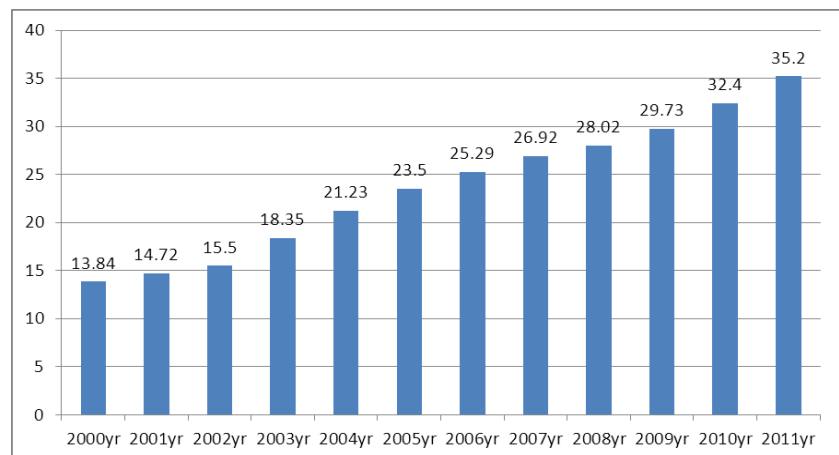
- ❖ **China is the largest coal production and consumption country, domestic & international coal prices are sensitive to the change of domestic supply and consumption.**
- ❖ **Coal as a major type of fossil fuel is an indispensable energy source to China in medium to long term.**
- ❖ **Despite of recent drop, still factors will potentially trigger coal price.**

Coal output and consumption in China

China is the world's both largest coal producer and consumer

Total output of coal in China increased by 8.65% yoy to 3.52 bn tonnes in FY11 (3.24 bn tonnes in FY10), representing a CAGR of 8.86% from 2000 to 2011. For the first 6 months this year, total output of coal grew by 7.7% yoy, because of weak economic situation. We forecast the 3Q and 4Q coal output would increase in view of growing demand, however, the overall year growth would remain stable at 8%~8.5% and will begin to rebound in 1H13.

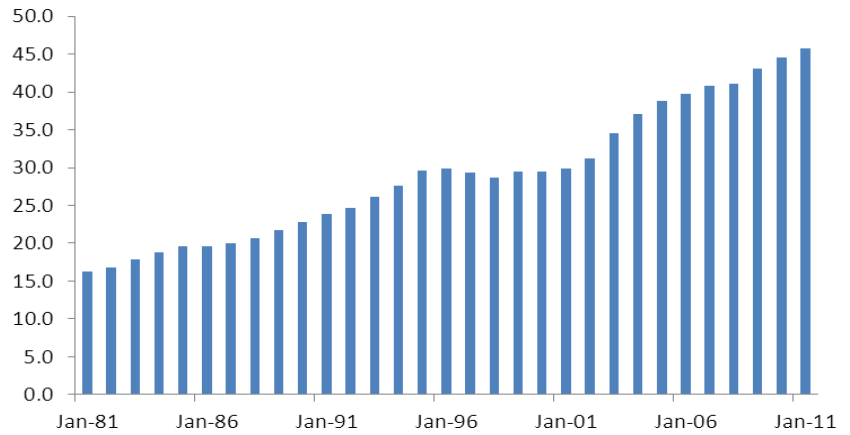
China's total coal production (billion tonnes, 2000~2012)



Source: WIND, ABCI Securities

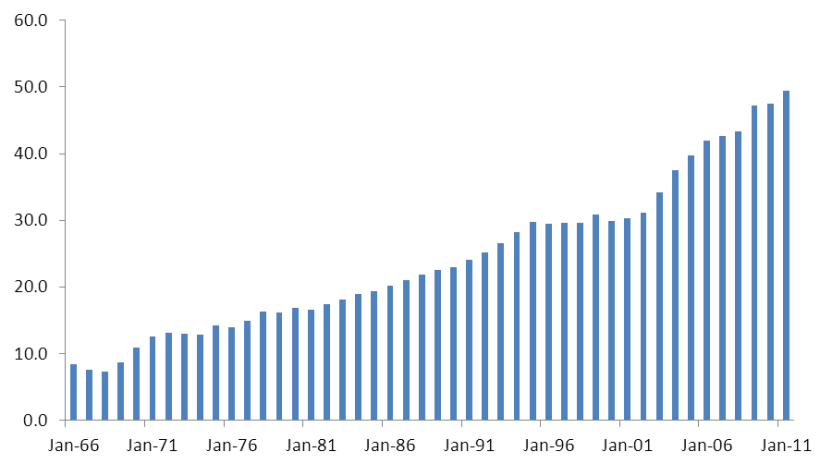


China's total coal production weight in the world (% , 2000~2012)



Source: BP Review 2012, ABCI Securities

China's total coal consumption weight in the world (% , 2000~2012)



Source: BP Review 2012, ABCI Securities



Coal is the most important fossil fuel energy in China

Coal is the major fossil fuel of China, accounting for 70.4% of the country’s energy consumption in 2011. According to the BP Statistical Review of World Energy June 2012 (BP Review 2012), total output and consumption of coal in China accounted for 49.5% and 49.4% of global production and consumption in 2011 respectively. Hence, domestic and international coal prices are sensitive to the change of domestic supply and consumption of coal.

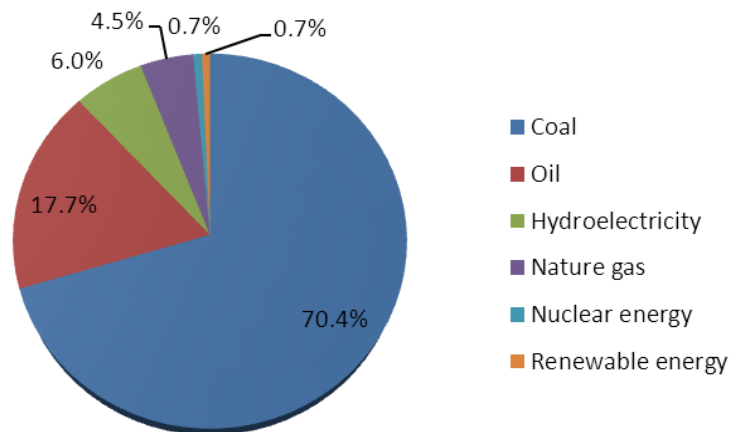
China’s 2012 forecast main energy consumption (mn tonnes of oil equivalent)

Energy Type	Consumption (2012 forecast) (mn tonnes of oil equivalent)
Coal	1,839.4
Oil	461.8
Hydropower	157.0
Natural gas	117.6
Nuclear energy	19.5
Renewable energy	17.7
Total	2613

Source: BP Review 2012, ABCI Securities

China’s 2012 forecast energy consumption distribution

(mn tonnes of oil equivalent)



Source: BP Review 2012, ABCI Securities

Downstream industries analysis

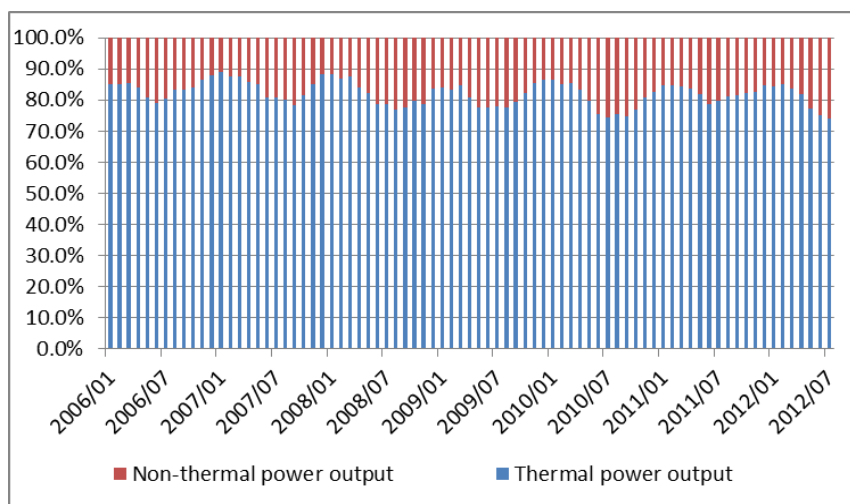
In China, most of the coal consumption consists of electricity generation, iron, building & construction materials such as cement and fertilizer. Among them, power generation weights the highest.

Thermal power is the largest coal consumer

In China, thermal, hydro, nuclear and wind power are the main sources of electricity generation. According to the statistics from the China Electricity Council (CEC), in 2011, thermal power, the most heavily used source of electricity generation in the PRC, had generated 3,897.5 TWh in 2011, representing 82.54% of the overall electricity generation in 2011.

We believe that the composition of electricity generation will not change dramatically in the near future. Thermal power remains the main source of electricity generation in China and its demand will not significantly reduced in the long run as long as China needs secure and large volume of power supply to sustain the industrialization and urbanization of the country.

China power output composition (% , 2006~2012)



Source: Bloomberg, ABCI Securities estimates

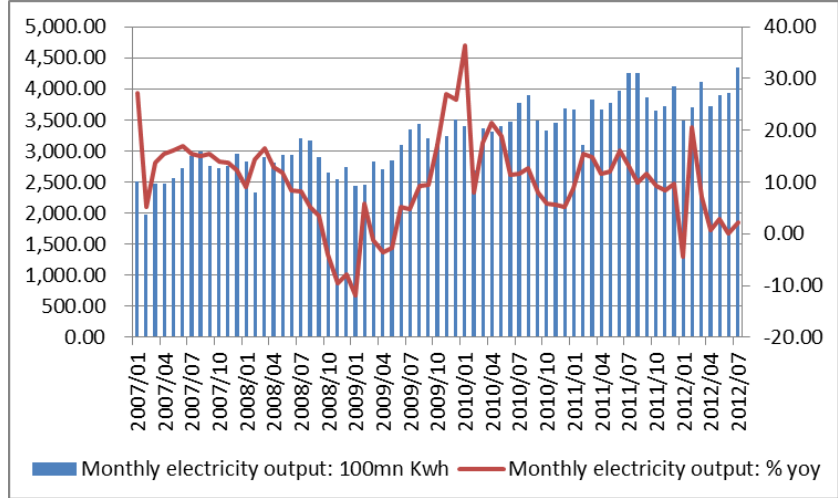
Demand for electricity slowed recently, but still at high level

According to the U.S. Energy Information Administration, China's power industry is the 2nd largest in the world after that of the U.S. CEC reports that 72.5% of China's total installed capacity of power plants (1,055.8 GW at the end of 2011) was thermal power. NBSC reports that the thermal power industry generated a total of 2,982.8 bn Kwh in 2009 and 3,825.3 bn Kwh in 2011, achieving a CAGR of 13.2%.

Owing to the slowdown of domestic economy this year, the demand for thermal power was reduced in 1H12. According to NBSC, the accumulated electricity output growth slowed down to 3.75% yoy for the first seven months this year (13.33% FY11 and 17.95% FY10). However, the absolute output of electricity and thermal power are both at historically high level.



China's electricity output (100mn Kwh, L-axis) & growth (% , R-axis)

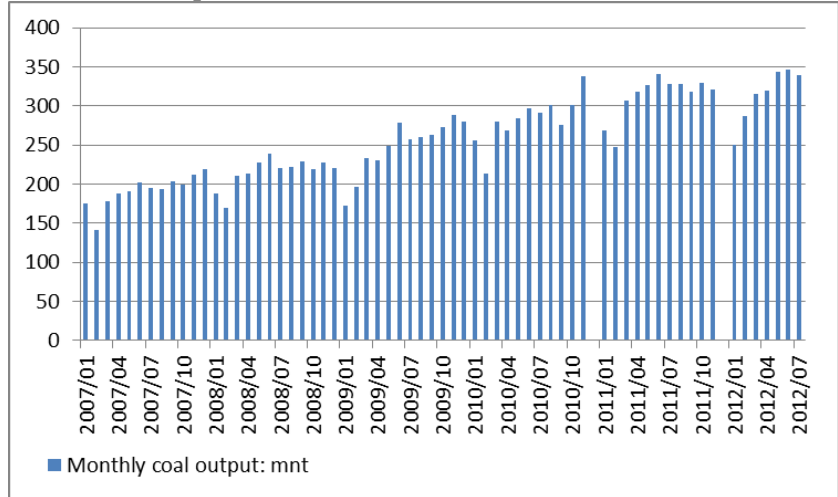


Source: WIND, ABCI Securities estimates

Weak coal market in 1H12, will resume and recover in 2H12

As power output growth slows down, demand for thermal coal reduced subsequently. Due to the reduction of domestic demand for thermal coal and the increase in domestic and import supply of thermal coal in 1H12, domestic thermal coal prices are under downward pressure. As coal price has been de-regulated for years, the movement of thermal coal prices is able to reflect supply and demand change of thermal power.

China's coal output (mn tonnes, 2007.01~2012.07)



Source: WIND, ABCI Securities estimates



Though the growth of the demand for thermal power as well as thermal coal encountered a slowdown in 1H12, **there are several factors which would potentially driver coal consumption in 2H12, and thus will also benefit China Shenhua accordingly:**

Firstly, economy would be stable in 2H12 and downstream demand would recover.

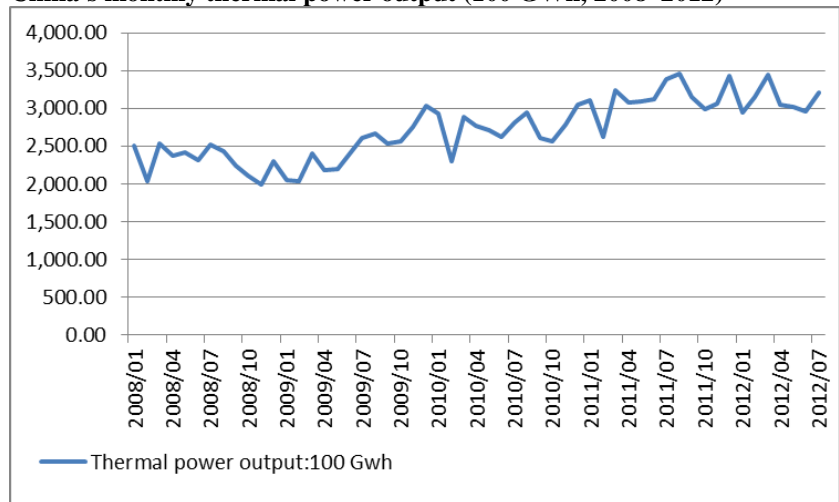
In view of China’s monetary and fiscal policies implemented last year and to be implemented this year, we anticipate the economy to stabilize in 4Q. We predict downstream demand for coal in power, steel and cement will be boosted in the 2H12 when government implements economic stimulus measures to bolster the economy for the rest of this year. The overall electricity consumption in 1H12 only improved 5.5% yoy, but CEC predicts that the growth rate will increase to 6~8% yoy in 2H12. Coal prices will be supported by recovering demand.

China Quarterly Real GDP Growth (% , yoy)

Period	Average	High	Low
Q1 2011- Q1 2012	9.06	9.70	8.10
Q1 2006 – Q4 2010	10.19	12.60	6.10
Q1 2001 – Q4 2005	8.91	11.20	6.60
Q1 1996 – Q4 2000	8.20	10.20	6.00

Source: NBSC, ABCI Securities estimates

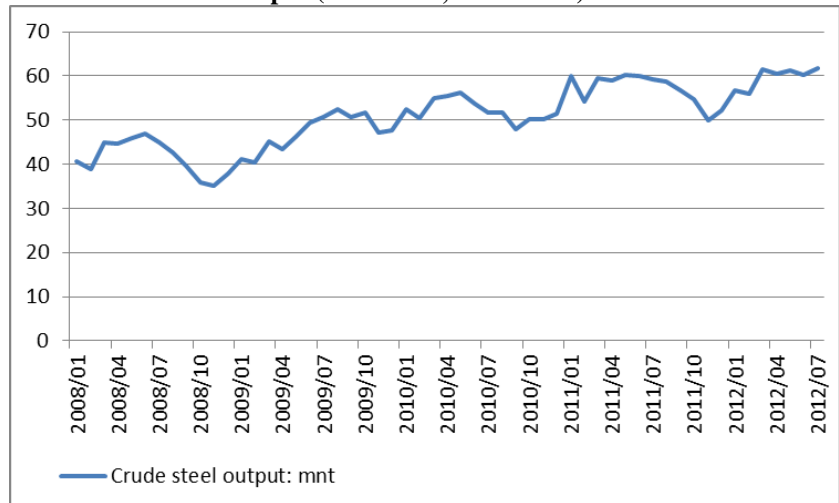
China’s monthly thermal power output (100 GWh, 2008~2012)



Source: NBSC, ABCI Securities estimates



China's crude steel output (mn tonnes, 2008-2012)



Source: NBSC, ABCI Securities estimates



Second, serious regional power shortage also trigger coal demand.

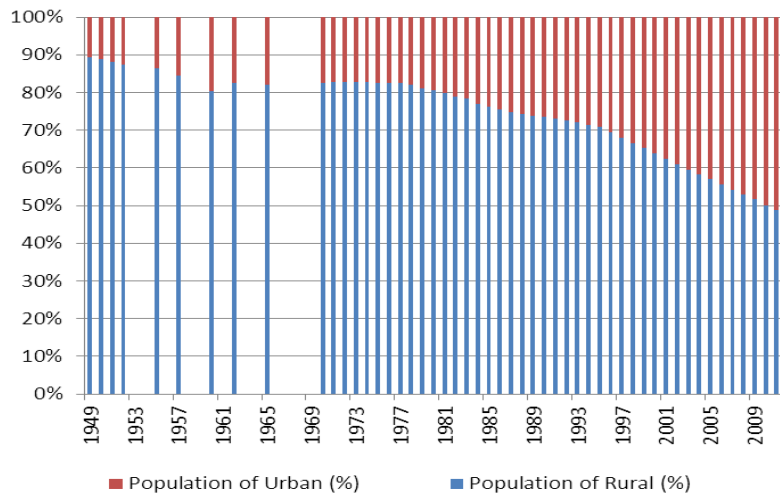
Due to China's unbalanced geographical coal distribution, many provinces are facing power shortage to support economic development (See Section *Unbalances in China's coal industry* for more details). According to China Electricity Council, in 2011, 24 provinces suffered from power shortage, with maximum shortage amount to 30 million. Our channel check finds that some traditional coal exporting provinces reduced exports to secure sufficient supply for local consumptions, which worsen the coal supply-demand relationship.

In addition, as coal prices decline and installed capacity increases, power generation operators have expressed higher incentive to generate sufficient power to meet the demand during the peak season this year as well as in coming years. This would boost more coal transportation to coal-shortage regions. However, China's railway construction dropped since 2011, and dropped 36.9% yoy in 1H12, we predict that the regional shortage would exist for years. However, we believe Shenhua will be in better position to fill these regional shortages, given its strong logistic capacity.

Third, China's urbanization would promote future coal consumption.

From 1949 to 2011, China's urban population greatly improved form 10.94% to 51.27% and is still on its way to expansion. We believe the trend would generate more demand for power and other downstream products such as building materials and steels, all these help to boost the coal consumption.

China's urbanization growth rate (1949-2011)



Source: NBSC, ABCI Securities estimates

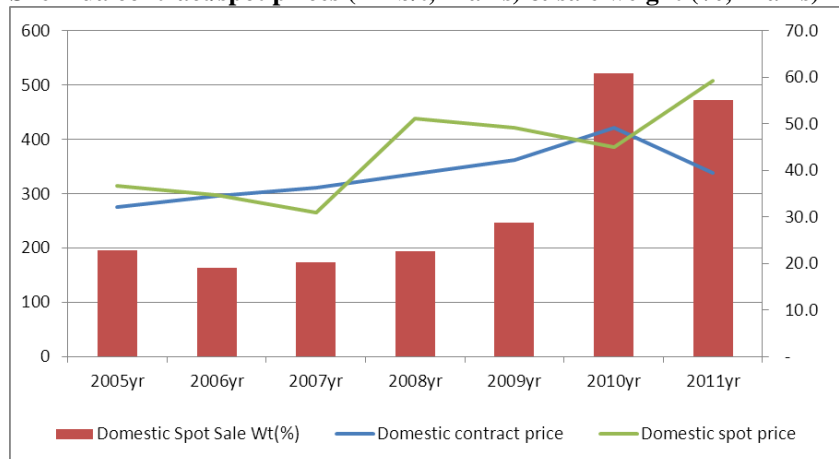


China's dual coal prices system and deregulation procedure

Special dual coal price system in China

Due to historical reasons, China still has dual coal prices system. For simplicity, long-term contract price is directly guided by the government and spot price is generated by the market players. Generally, large coal companies can sell under long-term contract to ensure transportation support while at the same time in spot market to gain more revenue. China Shenhua has improved its spot market exposure in recent years.

Shenhua contract/spot prices (Rmb/t, L-axis) & sale weight (% , R-axis)



Source: WIND, ABCI Securities

Since 2002, the price control was fully lifted by Chinese government, and the spot coal price improved rapidly. The difference between contract price and spot price was greatly enlarged and many coal companies became unwilling to implement the contract price, causing great pressure for power plants.

To control the situation, on November 30, 2011, NDRC implemented a new temporary price measures (NDRC 2011 No.299 Regulation), which set a ceiling price for the spot market transaction (See Appendix I). In fact, the regulation wouldn't effectively and heavily reduce the profitability of coal producers. In a downside market, the potential contract price is not likely to exceed the ceiling. In addition, producers with their own railway facilities can easily circumvent the No.299 restriction.

Spot price dropped significantly from May to July, providing a precious opportunity to solve the dual price problem. However, it is not easy to eliminate the dual price system, because coal price reform is associated with benefits of local governments, central government and the electricity pricing reform, which is complicated and time-consuming. In fact, though benefit from the drop of spot market, China's power producers still wish to keep the long-term contract system, so as to avoid potential coal price rebound.

In short, we believe that the coal firms with large bargain power and rich transportation sources would not suffer seriously from the price control.

Unbalances in China's coal industry

- ❖ Uneven distribution of the coal reserves
- ❖ Supply and demand locates in different regions
- ❖ Bottleneck in transportation enlarge supply-demand difference

Uneven distribution of the coal reserves

Just like that in other countries, coal reserves in China are abundant but unevenly distributed. So the geographic position of the coal mines plays an important role in influencing the firms' performance.

China has the third largest proved reserve of coal in 2011, according to BP Review 2012, But the coal reserves are mainly deposited in northern China and north-western China. Coal production in these areas not only accounts for a significant portion of the total coal production but also holds high quality coal reserves, and favorable geological conditions contribute to high coal production volume.

NDRC, in its 12th Five Year Plan (12th FYP) on Coal Industry, decided to improve the coal production in west and north-western, while at the same time control / limit the production in east areas.

12.5 Plan for coal production in China (2011-2015)

Regions	Development Plan	New construction scale (100mn tonnes/yr)	Weight (%)
West	Highly encourage	5.3	71.7
Central	Moderate encourage	1.85	25
East & northeast	Limit or control	0.25	3.3
	Total:	7.4	100

Source: NDRC

NDRC will lend more support to the coal development in Inner Mongolia, Shaanxi, Shanxi, Gansu, Ningxia, Ningxia, and Xinjiang. **We believe that those firms with large reserve in these regions (e.g. Shenhua) would benefit more from the 12th FYP.**

Supply and demand locate in different regions

Another significant unbalance in China's coal market is caused by different geographic position of the coal production and consumption.

In China, most industrial centers and many of China's coal-consuming enterprises are concentrated in the eastern and southern regions. NDRC predicts that in 2015, the net coal amount that to be transported across provinces will rise to 1.66 bn tonnes. And over 95% (about 1.58 bn tonnes) of that amount could come from of Inner Mongolia, Shaanxi, Shanxi, Gansu, Ningxia and Ningxia.

On the other side, the main receiving provinces would be Beijing, Tianjin,



Hebei provinces, east and northeast China. Generally, this kind of distribution would benefit the coal producers who have large coal reserves and railway system in the above mentioned area.

Coal supply and demand distribution plan during the 12th FYP



Source: NDRC

Bottleneck in transportation enlarge the supply-demand gap

According to NBSC, of the 3.52 bn tonnes of coal produced in 2011, 2.269 bn tonnes (about 64.5%) were transported by railway system. In China, national rail system is the primary supplier of long-distance coal transportation for many coal producers.

However, though China tried to increase rail capacity, its coal transportation system has been unable to fully satisfy the need for coal transportation. After the fatal 2011 Wenzhou high-speed lines crash, China suspended building new high-speed lines and worsen the transportation situation. We expect the inadequacy of coal transportation capacity to exist for the near future, and the transportation bottleneck won't be alleviated until 2017.

The shortage of coal transportation capacity is a bottleneck in coal industry, but not for China Shenhua. **With its self-owned coal railway line and coal ports, it enjoys significant competitive advantages.**

The underdeveloped transportation system and huge demand for thermal coal in recent years have driven up the internal coal price, which makes importing coal attractive, and finally turn China into a large coal importer in the world. China has been a coal net-importing country for three consecutive years since 2009. Its net import is 167.7 million tonnes in 2011, the largest coal importer in the world. This implies that without the transportation bottleneck, domestic coal producers might improve their sales by similar amount.

Company analysis: leading coal producer in China

Shenhua business overview and F12 outlook

Business composition of Shenhua

Product	Contribution to revenue [^] (%)	Gross profit margin* (%)
Coal	68.5	31.5
Power	28.3	21.1
Railway	1.3	48.1
Port	0.1	35.0
Shipping	1.4	14.2
Others	0.4	--

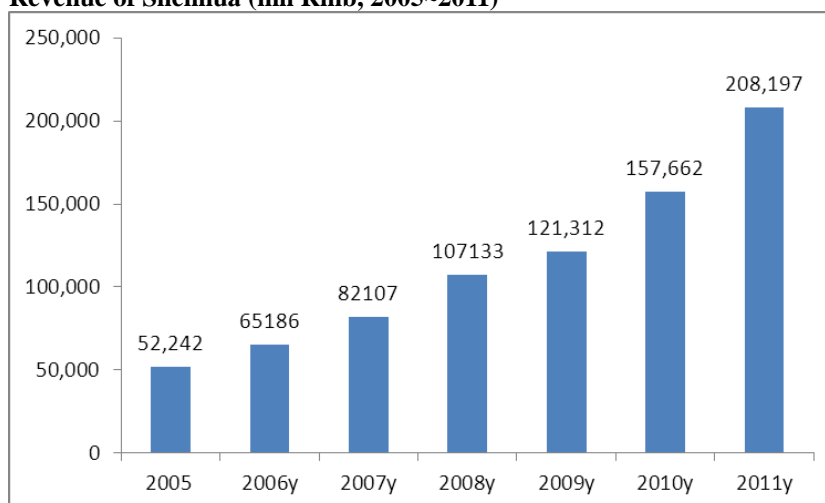
Source: Company, ABCI Securities

[^]: Based on FY11 revenue

*: In terms of sales volume of corresponding product segment in 2011

China Shenhua is a coal-based integrated company with five business segments: coal, power generation, railway, port, and shipping. Coal operation accounted for 68.5% of total revenue in 2011, while power generation and Railway contributed 28.3% and 1.3% respectively. The company's sales revenue was recorded at Rmb208.2 bn in 2011, representing a CAGR growth of 25.91% during the past 6 years.

Revenue of Shenhua (mn Rmb, 2005~2011)



Source: Company data, ABCI Securities

One of Shenhua's advantage is that it not only cover the upstream coal mining, but also cover coal related transportation and downstream sectors such as power generation and coal chemical (e.g. coal-to-oil). This enables it to achieve higher efficiency and profitability in each segment. Besides, it will be less sensitive to the variable coal price.

Coal segment: 68.5% of the FY11 revenue

Due to fast growth of China's economy and electric consumption, as well as the fast growing productivity of China Shenhua, the coal production/sales volume surged from 121.4/144.4 mn tonnes FY05 to 281.9/387.3 mn tonnes FY11, achieving a CAGR of 15.07/17.87%. At the end of FY11, Shenhua enjoyed 15,254 mn tonnes coal reserve, which provides high growing potential for Shenhua.

Shenhua's coal segment achieved revenue CAGR growth of 22.94% from FY05 (41,344 mnRmb) to FY11(142,718 mnRmb). In FY11, Shenhua's unit coal production cost for its commercial coal recorded at Rmb118.7/t, much lower than Rmb 344.71/t of China Coal (1898 HK) and Rmb 288.53/t of Yanzhou Coal (1171 HK).

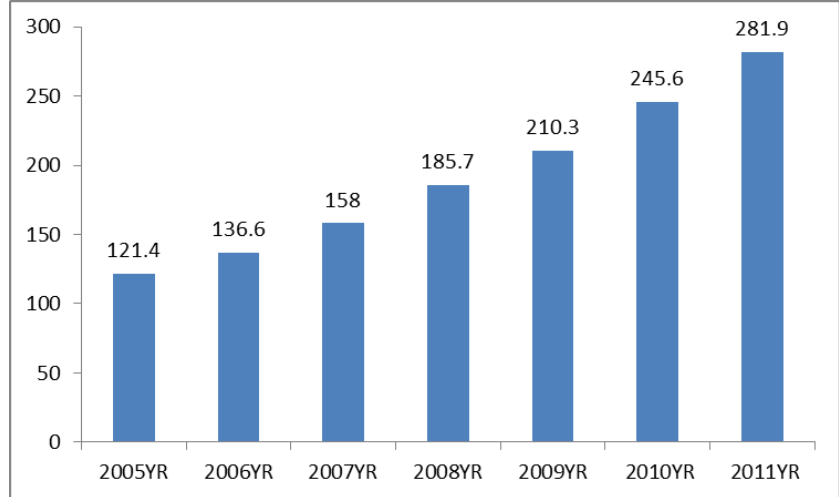
Though suffered from weak demand in 1H12, the total sales volume of Shenhua achieved 222.1 mn tonnes in 1H12, improved by 16.2% yoy. The production of saleable coal reached 155.8 mn tonnes 1H12, up 11% yoy. Since China resumed its infrastructure in 2H12, we predict the overall coal



China Shenhua Energy Company Limited

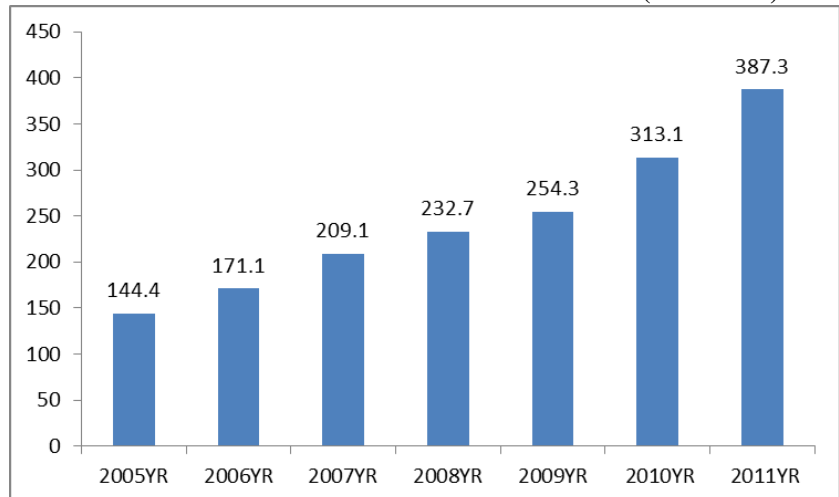
production/sale of Shenhua would meet the target of 289.9/420 mn tonnes, up 2.8% and 8.4% yoy, respectively.

Shenhua: Commercial coal production output (mnt, 2005~2011)



Source: Company data, ABCI Securities

Shenhua: Total coal sales volume to external customers (2005~2011)



Source: Company data, ABCI Securities



Breakdown of Commercial Coal Production

Breakdown of Commercial Coal Production (million tonnes)	2011
Shandong Coal Group	155.4
Bulianta	25
Daliuta-Huojitu	23.3
Yujialiang	16.8
Shangwan	13.9
Halagou	13
Baode(Kangjiatan)	10.1
Shigetai	11.2
Wulanmulun	6.6
Buer'tai	10.5
Wanli No.1 mine(Changhangou)	11.5
Liuta mine	6.0
Cuncaota No.1 mine	3.6
Cuncaota No.2 mine	3.3
Others	0.6
Zhunge'er Energy Company	29.2
Heidaigou	29.2
Ha'erwusu Branch	25.1
Beidian Shengli Energy	24.4
Jinjie Energy	17.1
Shenbao Energy Company	26.2
Baotou Energy Company	3.0
Shuiquan Open-cut Mine	1.8
Adaohai Mine	0.8
Lijiahao Mine	0.4
Chaijiagou Mining	1.0
Indonesia Coal Power	0.5
Total production	281.9
By Regions	
Inner mongolia	188.9
Shaanxi	82.4
Shanxi	10.1
Overseas	0.5

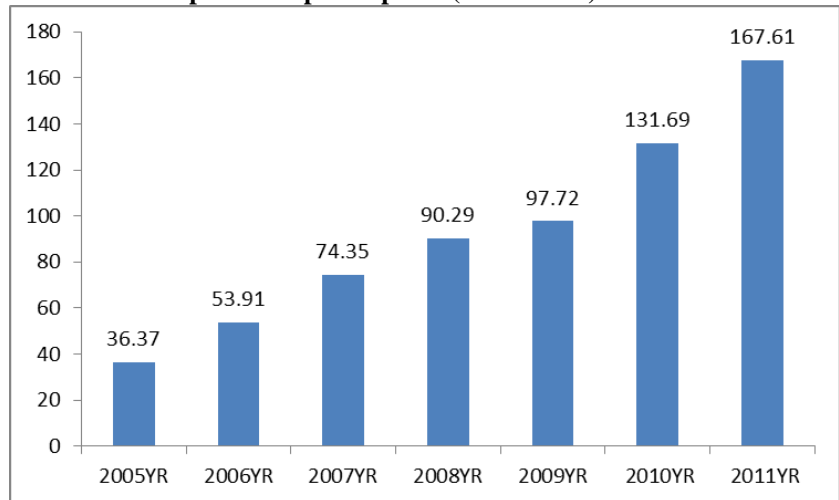
Source: Company data, ABCI Securities



Power segment: 28.3% of the FY11 revenue

The power segment has become the second largest business segment of China Shenhua. And the contribution of the segment is 28.3% in FY11, with gross power generation 179.97 bn kwh, up 27.2% and total power output dispatch recorded 167.61 bn kwh, up 27.3%.

Shenhua: Total power output dispatch (billion kwh)



Source: Company data, ABCI Securities

Shenhua's power segment benefits from its synergies with the coal section. Coal consumption from internal coal segment (64.2, mn tonnes) account for 80.1% of the total coal consumed by power segment (80.1%, mn tonnes) in FY11. Besides, the ASP of coal to the power segment was Rmb 390.4/t, 12.56% lower than that to external customers (Rmb446.5/t).

In 2011, the total power output dispatch amounted to 167.61 billion kwh, representing a year-on-year increase of 27.3%. The average utilization hour of the coal-fired generators of power segment was 5,914 hours, 620 hours more than 5,294 hours, the average utilization hour of national 6,000 kw and above coal-fired equipment in PRC.

Despite high growth of the coal price in FY11, the unit cost of power output dispatch of 2011 was Rmb275.2/mwh, increased only 4.0% yoy. In 2011, the gross profit margin of power segment is 21.1%.

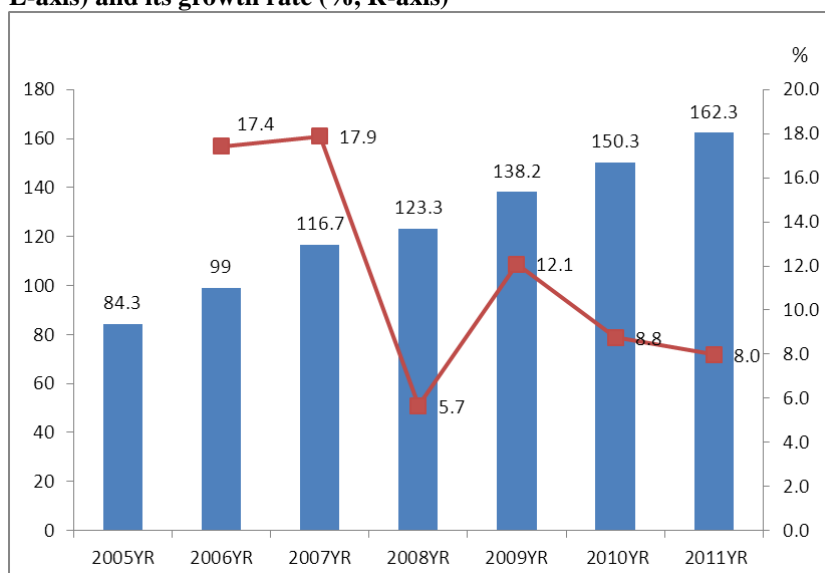
In 1H12, Shenhua achieved 167.6 (bn kwh) power output, 23.7% yoy high. In April 2012, Shenhua completed the acquisition of 50% equity interests of Guohua Taicang Power Generation Co., Ltd., 100% equity interests of Shenhua International (Hong Kong) Company Limited, and 60% equity interests of Bayannur Energy Co., Ltd. through business combination under common control. Accordingly, we predict that the FY12 power output target 199.6 (bn kwh) would be achieved, which indicates 19.1% yoy growth.

Transportation segment: Railway/Shipping/Port

In China, coal-consuming enterprises are concentrated in the eastern and southern regions, which is geographically far away from the coal-production center. Rail transportation is the main bottleneck for coal trading in China. However, transportation doesn't form a major constrain for Shenhua, because it is the only coal producer which owns its own coal railway system, coal port and shipment logistics.

The railway segment provides solid foundation for China Shenhua. The transportation turnover of self-owned railway was 76.5% of total turnover (78.2% for 2010). The capacity expansion and construction of new railways progressed smoothly during 2011. New transportation capacity is expected to be further released during 2013 to 2014.

Shenhua self-owned railway transportation turnover (bn tonnes km, L-axis) and its growth rate (% , R-axis)



Source: Company data, ABCI Securities

Shenhua: breakdown of railway turnover

	2011 bn tonne km	2010 bn tonne km	Change (%)
Self-owned railways	162.3	150.3	8.0
Shenshuo Railway	39.8	37.1	7.3
Shuohuang-Huangwan Railway	96.4	88.8	8.6
Dazhun Railway	17.5	16.2	8.0
Baoshen Railway	8.6	8.2	4.9
State-owned railways	49.8	41.8	19.1
Total railway turnover	212.1	192.1	10.4

Source: Company data, ABCI Securities



Shenhua-Map of the self-owned railway lines the two ports

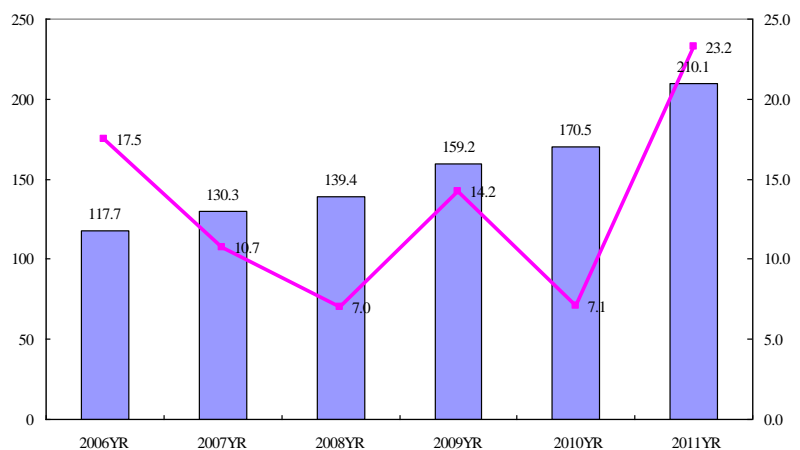


Source: Company data

In addition to its strong railway system, Shenhua has a sizeable and rapidly growing port and shipment business. Though these sectors do not weight heavily in the total revenue, they significantly lower the cost of transportation for the coal business.

The unit cost of internal transportation service provided for the Group was Rmb14.2/tonne (2010: Rmb15.6/tonne), representing a decrease of 9.0% yoy. In 2011, Shenhua's own ports proved 121.2 mn tonnes of seaborne coal transportation (10.5% yoy improved), accounting for 57.7% (64.34% in FY10) of the total 210.1 seaborne coal.

Shenhua- Seaborne coal transportation (million tonnes)



Source: Company data, ABCI Securities



Positive triggers for choosing China Shenhua

- ❖ Industrial consolidation continues to tighten supply
- ❖ Largest coal reserve with high quality
- ❖ Strong logistics with integrated transportation network
- ❖ Vertical integration of coal and power make Shenhua defensive
- ❖ Positive triggers supporting coal prices in the near future

Industrial consolidation continues to tighten supply

i) China plans to reduce the coal capacity and supply

China is restructuring coal industry by eliminating small and medium size coal miners and foster large and competitive coal groups. According to China's 12th FYP, the overall coal production should be controlled under 3.9 bn tonnes, indicating a slowed CAGR of 2.6% from 2011~2015.

However, this does not mean that all coal producers will reduce their production equally. Alternatively, China would vigorously promote mergers and reorganizations among coal mines enterprises, shut down backward production capacity, and develop large coal group companies. At the end of 2015, China plan to form ten 100-million-tonne-level large coal enterprise groups and ten 50-million-tonnes level large coal enterprise groups, output of which shall constitute more than 60% of the national output. We estimate that the market share of top 20 coal firms will improve to over 63% in FY15 (vs. 50% FY10).

As the largest coal producer in terms of coal production, coal sales and reserves in China, Shenhua has engaged in the policy decision procedure and will benefit from the dynamic industrial change.

ii) Industrial entry barriers significantly improved

China has strictly limited the number of coal licence in the coal mine area in recent years. Based on the principle of “one developer for one coal mine area,” mergers and reorganizations plans shall be made and implemented for each coal mine area, to reduce the number of coal mine developers.

Largest coal reserve with high quality

To ensure sustainable growth, coal enterprises compete for new resources, the exploration and development of which are subject to governmental approval.

As at 31 December 2011, the Group's coal resources reserve, recoverable coal reserve under PRC standard and marketable coal reserve under JORC standards amounted to 25.400 billion tonnes, 15.254 billion tonnes and 9.346 billion tonnes respectively.

Besides, most of the coal reserves of Shenhua are in the high quality coal mine areas such as Inner Mongolia, Shaanxi and Shanxi, which are also the areas heavily supported by NDRC's 12th FYP.



Strong logistics with integrated transportation network

Different geographic position of the coal production and consumption causes significant unbalance in China's coal market. The suspension of the railway investment in FY11 deteriorates the transportation bottlenecks, which will be the main obstacle for coal producers in the next few years.

According to NDRC's prediction, by 2015, the net coal amount that to be transported across provinces will rise to 1.66 bn tonnes, over 95% (about 1.58 bn tonnes) of which should be transported from of Inner Mongolia, Shaanxi, Shanxi etc. to the main receiving provinces/municipalities such as Beijing, Tianjin and Hebei provinces.

Coal enterprises, especially those in the Tri-West Area, rely heavily on the national railway system and compete for the transportation quota. They also compete in constructing local railways and roads to assure access to the national railway system.

We believe this situation would benefit Shenhua most, since its own railway lines and coal port cover the above area. By using its own railway system, coal port, and shipment, Shenhua not only met over 76%, 57.6% and 100% of its own demand on the relevant transaction methods (FY11), but also made profit by providing the transportation service to the 3rd party.

Vertical integration of coal and power make Shenhua defensive

Vertical integration of coal production and power generation make Shenhua more defensive against present volatile coal price. Coal enterprises compete for long-term customers and sales contracts based on product quality and transportation capacities which can better support their production and operations.

In 2011, the sales volume of the company to the top five domestic coal customers was 45.5 million tonnes, accounting for 11.9% of the total domestic sales volume, of which, the sales volume to the largest customer was 12.8 million tonnes, 3.4% of total domestic sales volume. The top five domestic coal customers were primarily either power generation companies or fuel companies.

Shenhua could seek to take advantage of government's initiatives of closing small coal mines and carry out industry consolidation. They compete for opportunities involving potential mergers with, and acquisitions of, smaller coal enterprises with considerable coal reserves and good coal quality.

Positive triggers supporting coal prices in the near future

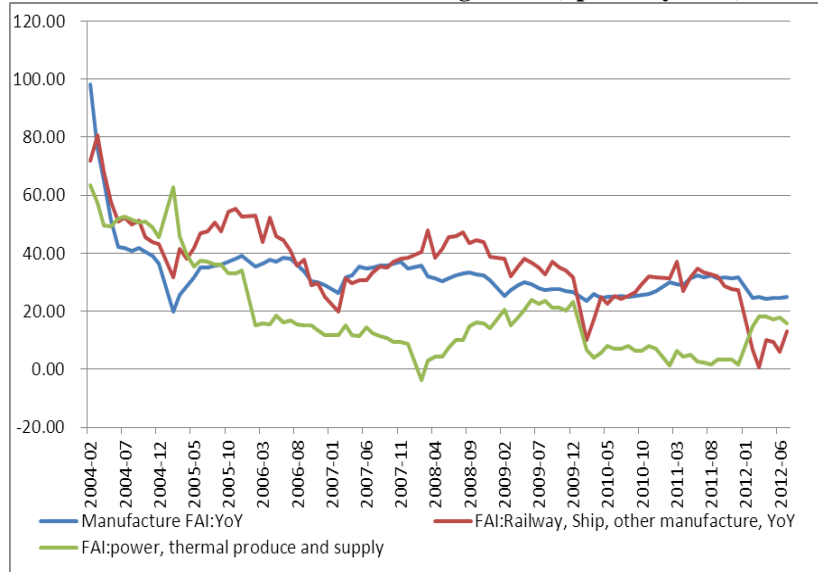
Until recently, there is still no explicit signal indicating how long-term contract price will be reached in 2013. Based on our channel checking, neither power producers nor coal producers are confident on the prediction of next years' price. **However, we do notice some positive signals:**

1) Downstream demand for coal in industries such as steel, cement and fertilizer remains solid in the 2Q and will be boosted in the 2H12 when government implements further economic stimulus measures to bolster the economy for the rest of this year. We notice that the FAI for railway, ship and other manufacturing industry has risen significantly recently. Coal prices will



be backed on recovering demand.

Fixed asset investment in manufacturing sector (up to July 2012)



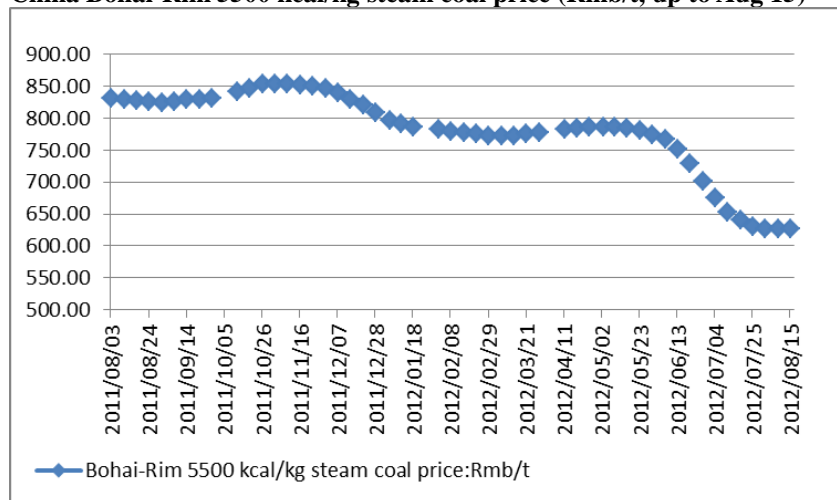
Source: WIND, ABCI Securities

2) The demand for thermal power increases recently. China's State Electricity Regulatory Commission (SERC) reports that July recorded 453,690 GWh power generation, up 6.7% yoy, or 15.3% mom. Due to high temperature, peak electricity reached 15,200 GWh (July 11), 0.77% higher than last year (July 26, 2011). All these benefit coal price.

Also, price drop in 2Q caused many small & medium-sized coal miners to cease or reduce production, esp. those in Inner Mongolia and Shaanxi. We anticipate their market shares will be displaced by large miners such as Shenhua. Its strong logistic operation is the edge of the business. With less coal capacity, the coal price would be supported in the medium term.

Recently, Bohai-Rim 5500 kcal/kg steam coal price and QHD 5500 kcal/kg steam coal price have been stabilized in the past three weeks.

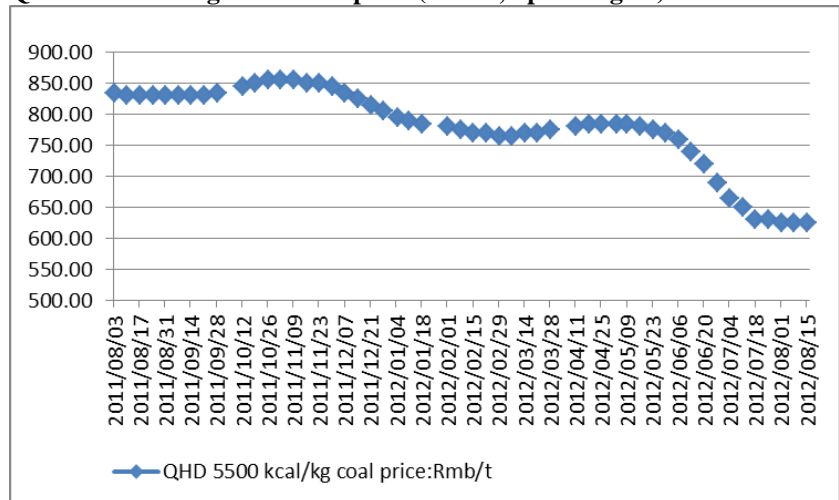
China Bohai-Rim 5500 kcal/kg steam coal price (Rmb/t, up to Aug 15)



Source: WIND, ABCI Securities



QHD 5500 kcal/kg steam coal price (Rmb/t, up to Aug 15)

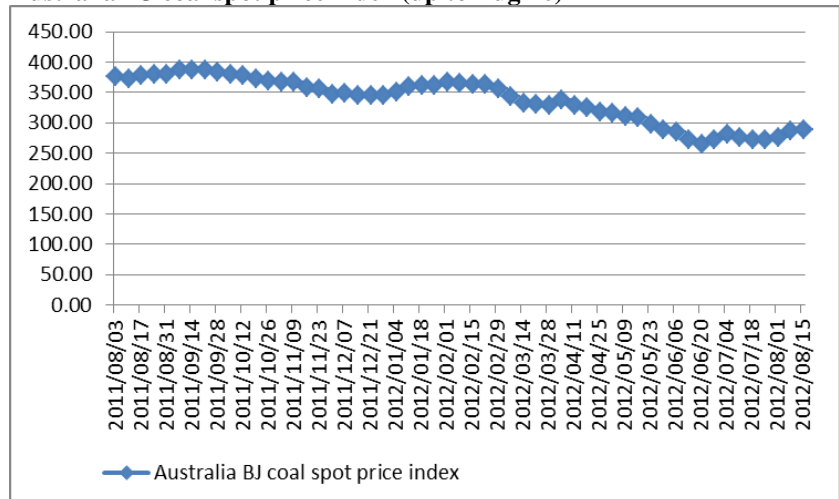


Source: WIND, ABCI Securities

3) Though 1H12 has witnessed seriously price drop in the spot market, we are not too pessimistic in the contract price in both medium and long term perspective. Unlike the spot price which dropped seriously in 1H12, the long-term contract price did not drop and even exceeded the 5% yoy ceiling limit set by NDRC for many coal companies in 1H12.

4) After significant decrease, international coal price has begun to be stabilized. This would provide support for the internal coal price.

Australia BJ coal spot price index (up to Aug 16)



Source: WIND, ABCI Securities

ii) More economic stimulus will take effect in 2H12.

China's CPI and PPI both dropped in July, reflecting weak economy situation. We expect government to launch various fiscal and monetary stimulus policies to bolster the economy. Systematic risk of coal stock will reduce.

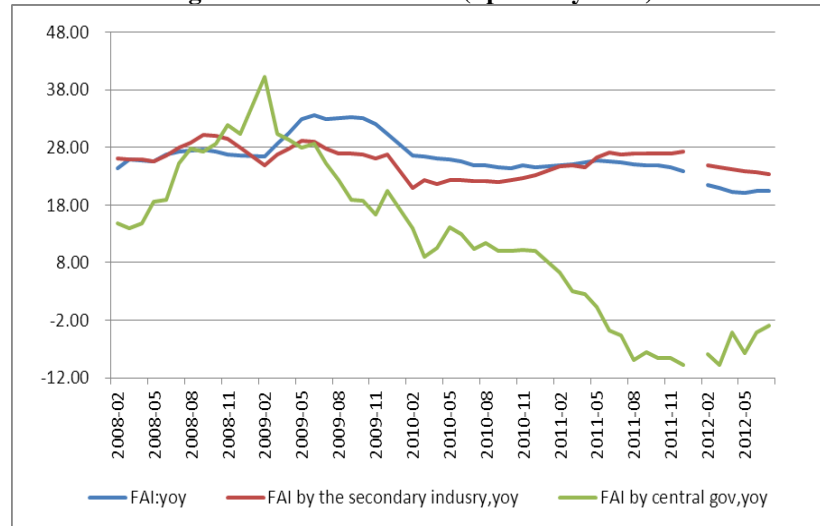
Though we see July CPI and PPI scores 1.8%/ -2.9% yoy, 30/33 months low, FAI shows good signs, which has stabilized in July in terms of overall investment and the 2nd industry investment. Especially, FAI from central



China Shenhua Energy Company Limited

government began to increase. We predict that due to the lagged effect, government investment should show their effect in 4Q. However, the coal demand would be supported in this procedure, as well as the coal price.

China FAI and government investment (up to July 2012)



Source: WIND, ABCI Securities



Financial analysis and projection

Revenue expectations and earnings outlook

China Shenhua's revenue highly concentrated in the coal and power segments. The cyclical downturn of spot coal market in 1H12 adversely affected the sales performance of the firm, we believe that due to the weak recovery from downstream consumption and the competition from overseas, coal prices would not jump up in a short time. Thus, its total revenue would be significantly reduced. However, Shenhua could improve its revenue by improving its own coal production and enlarge its power business.

In return, we predict that total revenue of Shenhua will grow at a CAGR of 14.58% from FY11 to FY14, cooled down from 24.79% from FY08 to FY11. The slowdown of the sales growth is due to the high-base effect and the weak economic development of China. We estimate that revenue in FY12, FY13 & FY14 are 237.39, 272.07 and 313.20 bn Rmb, respectively.

Shenhua-Key assumptions for revenue prediction and earnings outlook

	2010A	2011A	2012E	2013E	2014E
% of coal sale to outside	81.2	81.0	81.0	81.0	81.0
outside/internal price (%)	102.0	102.4	102.4	102.4	102.4
Coal sector weight (%)	69.0	68.5	66.1	63.7	61.2
Power sector weight (%)	28.7	28.3	30.7	33.2	35.8
Coal sector					
Total sales (mn tonnes)	313.1	387.3	420	456	495
Weighted ASP (Rmb/t)	409.4	435.8	442.1	449.5	457.8
Sales to external customers (mn tonnes)	254.2	313.8	340	369	401
Price to external customers (Rmb/t)	417.4	446.5	453	460	469
Power sector					
Power sales growth (%)	-	27.3	19.09	19.09	19.09
Power revenue growth (%)	-	30.2	24.0	24.0	24.0
Gross profit margin (%)	42.8	38.5	32.0	32.0	32.0

Source: company data, ABCI Securities



Earnings expectations and sensitivity

We forecast net earnings for Shenhua of 48.74/55.68 Rmb bn in 2012/2013, about -7.2%/14.2% yoy respectively assuming 1.44%/1.44% yoy increase in its weighted average coal selling price. Below are the earnings sensitivities in our model to changes in coal price, coal sales and power output. We estimate its earnings sensitivities in 2012 as follows:

+/-5% change in weighted average price ~ 4.06/-4.06% change in net income

+/-5% change in coal sales to external ~ 4/-4.14% change in net income

+/-5% change in power output ~ 1.89/-1.82% change in net income

Sensitivity test on 2012 estimated net income (mn Rmb)

Net Income	2012E	Rise5%	Chg	Down5%	Chg
Coal ASP change	42,398	44121	4.06%	40675	-4.06%
Coal sale to external	42,398	44092	4.00%	40643	-4.14%
Power output	42398	43200	1.89%	41626	-1.82%



Financial Statements Projection

Consolidated income statements forecast

FY ended Dec 31 (Rmb mn)	FY10A	FY11A	FY12E	FY13E	FY14E
Revenue	157,662	208,197	237,392	272,070	313,204
Coal	108,774	142,718	156,989	173,226	191,567
Power	45,194	58,845	72,953	90,444	112,128
Others	3,694	6,634	7,450	8,401	9,509
Cost of sales	(90,142)	(128,092)	(161,426)	(185,008)	(212,979)
Gross profit	67,520	80,105	75,965	87,062	100,225
SG&A	(9,219)	(10,973)	(12,619)	(14,512)	(16,689)
Other operating expenses	(776)	(827)	(868)	(912)	(957)
EBIT	57,525	68,305	62,478	71,639	82,579
Finance income	1,397	1,082	1,239.5	1,160.75	1,200.125
Finance costs	(3,645)	(3,218)	(2,414)	(2,655)	(2,920)
Other income	665	291	392	341	366
Pre-tax profit	55,942	66,460	61,696	70,486	81,226
Profits tax	(11,473)	(13,951)	(12,956)	(14,802)	(17,057)
Net profit	44,469	52,509	48,739	55,684	64,168
Minority interests	5,635	6,832	6,342	7,245	8,349
Equity shareholders of the Company	38,834	45,677	42,398	48,439	55,819
EPS (Basic)	1.952	2.296	2.132	2.435	2.806

Balance sheet forecast

FY ended Dec31 (Rmbmn)	FY10A	FY11A	FY12E	FY13E	FY14E
Property, plant and equipment	188,061	219,904	263,885	337,773	405,327
Construction in progress	33,088	34,169	39,978	41,977	41,977
Intangible assets	3,248	3,596	4,315	4,473	4,473
Other assets	28,273	35,471	39,502	40,917	41,651
Total non-current assets	252,670	293,140	347,679	425,139	493,428
Inventories	11,574	12,628	15,154	19,700	25,610
Accounts and bills receivable	11,424	13,365	16,038	19,246	23,095
Prepaid expenses and other current assets	14,250	12,884	14,172	15,590	17,149
Cash and cash equivalents	77,212	61,437	53,026	50,244	46,423
Other current assets	5,001	7,623	9,148	8,233	7,410
Current assets	119,461	107,937	107,538	113,012	119,686
Total assets	372,131	401,077	455,217	538,151	613,114
Short-term borrowings and current portion of long-term borrowings	15,317	16,389	21,306	27,697	36,007
Accounts and bills payable	19,661	23,668	30,484	39,264	50,572
Accrued expenses and other payables	41,948	47,492	57,756	75,023	91,334
Total current liabilities	76,926	87,549	109,546	141,984	177,913
Total non-current liabilities	57,778	49,214	49,225	63,011	59,742
Total liabilities	134,704	136,763	158,771	204,995	237,655
Total equity	237,427	264,314	296,446	333,156	375,460
Non-controlling interests	32,314	38,492	38,492	38,492	38,492
Book value per share (Rmb)	10.313	11.354	12.969	14.815	16.942



Consolidated cash flow statements forecast

FY ended Dec 31 (Rmb mn)	FY10A	FY11A	FY12E	FY13E	FY14E
Profit before income tax	55,942	66,460	61,696	70,486	81,226
DD&A	13,698	15,571	18,389	20,528	22,691
Interest income	(1,248)	(968)	(1,240)	(1,161)	(1,200)
Net interest expense	3,180	3,131	1,174	1,494	1,720
Others	(720)	462	8,072	13,558	12,056
CF Operating	70,852	84,656	88,091	104,906	116,493
Capex	(30,538)	(44,713)	(58,753)	(70,503)	(84,604)
Others	(594)	(10,137)	330	1,071	3,654
CF Investing	(31,132)	(54,850)	(58,423)	(69,432)	(80,951)
Net debt financing	(10,677)	(16,143)	(10,452)	(6,350)	(2,357)
Dividend payout	(12,890)	(17,659)	(16,608)	(18,974)	(21,865)
Others	1,019	2,219	3,106	3,360	3,631
CF Financing	(22,548)	(31,583)	(23,954)	(21,964)	(20,591)
Net change in cash	4,893	(15,768)	(8,416)	(2,787)	(3,826)
Cash at the beginning	72,321	77,212	61,437	53,026	50,244
Exchange difference	(2)	(7)	5	5	5
Cash at the end	77,212	61,437	53,026	50,244	46,423

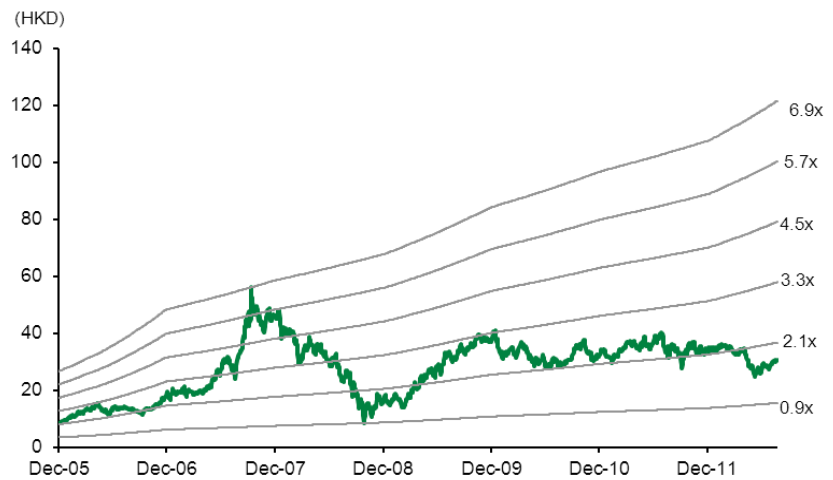
Source: Company data, ABCI Securities estimates



Valuation

We use both PB and PE multiple methods to appraise the stock. Based on the PER rating, the stock is currently traded at 11.4x PE (or 1.9x PB) for FY12. We set the 12-month target price of HK\$34.5, which represents 13.16x PE for FY12, or 2.16x PB for 2012, and is 15.8% higher than current price. We initiate with BUY rating.

China Shenhua P/B band chart (up to Aug 22, 2012)



Source: Bloomberg, ABCI Securities

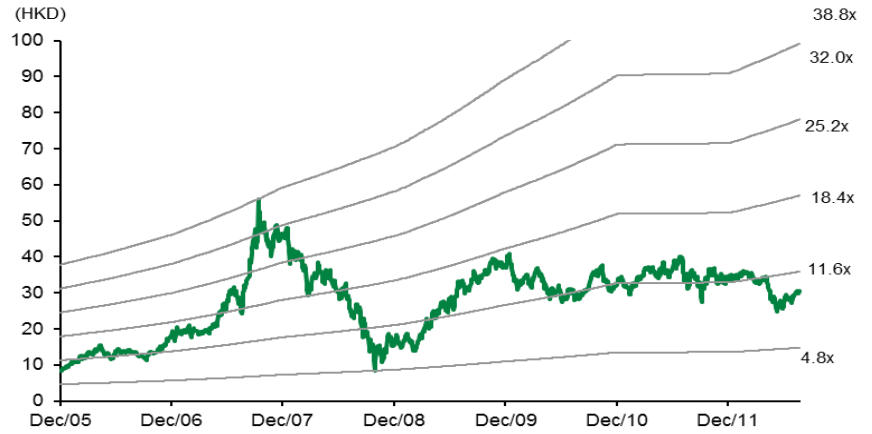
China Shenhua P/B distribution chart (up to Aug 22, 2012)



Source: Bloomberg, ABCI Securities



China Shenhua P/E band chart (up to Aug 22, 2012)



Source: Bloomberg, ABCI Securities

China Shenhua P/E distribution chart (up to Aug 22, 2012)



Source: Bloomberg, ABCI Securities



Peer Group Comparison

FY11	China Shenhua	China Coal	Yanzhou Coal
Code	1088	1898	1171
Business summary			
Commercial coal production (mn tonnes)	281.9	102.79	50.911
Coal sales (mn tonnes)	387.3	134.70	64.25
Gross power generation (Bn kwh)	179.97	0.427	1.367
Total power output dispatch (Bn kwh)	167.61	NA	0.933
Coal resources (100 mn tonnes)	254	196.4	45.48
Coal production cost for saleable coal (Rmb/t)	118.7	344.7	288.5
Financial Data			
Revenues (Rmb mn)	208,197	87,773	47,066
Profit for the year (Rmb mn)	52,509	10,659	8,976
Profit to equity shareholders (Rmb mn)	45,677	9,802	8,928
Total assets (Rmb mn)	401,077	159,933	97,152
Total liabilities (Rmb mn)	136,763	63,968	53,827
ROAA (%)	11.8	6.9	10.5
ROAE (%)	21.2	12.6	22.3
Dividend (inclusive of tax) (Rmb per share)	0.9	0.215	0.57
Dividend Yield (%)	3.7	3.7	5.9
Basic EPS (Rmb per share)	2.296	0.74	1.82
BVPS (Rmb per share)	11.354	6.165	8.67
PBx	2.1	0.9	1.1
PEx	10.6	7.8	5.2
Net debt(Net Cash, mn Rmb)	(4479)	(2379)	18951
Mkt Cap (mn Rmb, by Aug22, 2012)	444,121	90,990	73,275
EV (mn Rmb, by Aug22, 2012)	442,642	88,612	92,226
EV/Coal Resources (Rmb/t)	17.43	4.51	20.28

Source: Bloomberg, ABCI Securities



Risk factors

Economic risk: The macro economy is slowing down. There would be weak power consumption growth on slowed economic growth. Though we believe that Chinese government would impose monetary and fiscal measures to boost the economy, we do not expect a U-shape recover. On the contrary, L-shape is the lucky one. Accordingly, the power generation, though will recover in 3Q and 4Q, will be still slowed on yoy basis.

Competition from foreign coal producers: The influx of foreign coal cap the rebound momentum of domestic coal prices. According to an EIA investigation, the weight of thermal power generation to the total power would reduce 14% yoy. More and more American coal producers turn to India and China market, which would increase the supply of coal to China.

Increasing cost due to business development and social responsibility: Unlike the private firms, state-owned enterprises in China lack the freedom to cut its employees, as they are more required to bear social responsibility. China's inflation and salary have kept jumping in the past few years, if coal price keeps dropping, it will put more pressure on the profitability of the firm. Other factors that might increase Shenhua's cost include: 1) its new incremental production; 2) increasing cost in M&A activities in the vertical business integration; 3) potential resource tax which has been discussed widely.

Cautions on asset injections: On 23 May 2012, Shenhua announced that it will acquire *China Shenhua Coal Liquefaction and Chemical Co., Ltd.* and *Shaanxi Shenyan Coal Co., Ltd.*, from Shenhua Group Co. It is a big step in the coal-to-oil business. However, we concern the efficiency and profitability of the oil transferred from coal. If Shenhua cannot achieve economic-scale effect, the cost of the coal-to-oil business would be high. Also, if the world crude oil price dropped, Shenhua would also be suffered.

Policy risk: China is implementing its energy saving policy, and many more new measures would be implemented. One of the directions is to reduce the carbon emission and reduce the weight of thermal power generated in the overall power consumption. This would likely dampen coal consumption.



Appendix I –China’s dual coal prices system and NO. 299 Regulation

The contract price is generally discussed between coal and power producers, as well as the transportation department, in 4Q and is set in the coming spring.

A temporary measure was enforced to avoid unusual fluctuations in thermal coal prices prior 2006. This, along with other reasons, caused thermal contract price to be generally lower than spot price during the period.

On December 27, 2005, NDRC eliminated the temporary intervention measure, completely removing control over thermal coal prices. But NDRC still often intervened in the pricing procedure.

The spot price has been mainly market-decided since 2002, when China lifted price control for thermal coal. It consist of at least three main types of pricing mechanisms: mine mouth (mine gate), direct arrival along railway line (free-on-rail or “FOR”) and seaborne (free-on-board or “FOB”).

- i. Mine gate price refers to the sales price of coal sold at the producing mines.
- ii. FOR price refers to the sales price when the coal is loaded onto trains, which is mainly impacted by the mine gate price, freight charges (usually short-distance trucking), platform fee and agent fee.
- iii. FOB price refers to the price of coal loaded onto ships for export markets.

With the growing demand for imported coal, the international coal price began to attract more eyes in recent years.

Though Chinese government plans to move to a market-decision mechanism for thermal coal price, it face quite challenge to totally remove the dual price system. Because the coal price directly and heavily influence the electricity price, which is essential to reducing the overall inflation.

The most recent price control regulation is No. 299 Regulation by NDRC.

What is the NO. 299 Regulation?

When the price control was fully lifted in 2002, the spot coal price improved rapidly. The difference between contract price and spot price was enlarged in recent years and many coal companies became unwilling to implement the contract price, causing great pressure for electricity producers.

To control the situation, on November 30, 2011, NDRC implemented a new temporary price measures (NDRC 2011 No.299 Regulation), which :

- (i) sets price ceiling for the long-term contract price:
 - (a) for the cross-provincial crucial contract coal, the contract price should not exceed 5% of relevant price in 2011;
 - (b) for the thermal coal generated and used by the province (district, city) which itself generates coal, the annual increase in contract prices should not exceed 5% of contract prices of last year;
- (ii) sets capped prices for the thermal coal in market transactions:
 - (a) since January 1, 2012, the FOB price of thermal coal with a calorific value of 5,500 kcal/kg at nine major ports including Qinhuangdao port, Tian Jin port and Jingtang port should not exceed



Rmb800 per tonne.

(b)FOB price of other thermal coal should be calculated correspondingly based on the capped price of thermal coal with a calorific value of 5,500 kcal/kg.

(c)The market transaction price of thermal coal transported by railway and highway by the parties should not exceed the actual accounting settlement price of the end of April 2011, and should not increase the price by way of changing accounting settlement means.



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Disclosures

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