Corporate Snippet

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More upside is expected | Hong Kong Conglomerate

COSCO International (517 HK, HK$3.08) | Not Rated

Company background. After years of restructuring and disposal of non-core assets, COSCO International (the group) repositioned itself as one of China's leading marine services providers. It is engaged in the manufacture/sales of marine/container coating, provision of marine insurance brokerage service, vessel trading and supplying service. COSCO Group, which owns 58.0% of the group, operates a fleet of more than 700 vessels with a total carrying capacity of up to 41.0m Dead Weight Tons (DWT) and has ranked first in international bulk shipping sector for years. It is also listed as one of the world's top ten container liner operators. Its fleet includes container vessels, dry bulk carriers, oil tankers, general cargo ships, heavy-lift carriers and specialized vessels. With its parent's backing, the group's marine service business should offer great expansion potential, with high earnings visibility. Besides, through its 44.0%-owned Sino Ocean Real Estate Development Group (SORED), the group has exposure to the booming property market in China.

Investment case. Although its share price surged 121.6% YTD, trading at ex-cash P/E of 7.1x for FY12/07F and 6.5x for FY12/08F, according to market consensus EPS forecasts, the group remains undervalued, in our view. The listing of its property development arm, SORED, should be the major share price catalyst this year, while its HK$1.1b cash on hand should serve as a war chest for EPS accretive acquisitions. On the back of global fleet expansion, organic growth in its marine services is expected to be robust. The group has also been streamlining its business by disposing non-core assets. In FY12/06F, it sold its 54.0% stake in Henan Xin Zhong Yi Electric Power Co. for RMB43.8m and 10.0% in International Paint of Shanghai for RMB39.0m. It also disposed of a site in Kutong, New Territories. It is estimated that the group realized a disposal gain of HK$45.0m and received a cash inflow of HK$93.0m in FY12/06F from the transactions. The shedding of non-core assets will release capital for the development of its core marine services. Major risk factors include more austerity measures in China, higher crude oil prices, sentiment changes in China's property development sector and slower GDP growth in China and globally.

SORED - hidden treasure. With its land bank of about 7.0m sq.m, SORED is one of Beijing's leading property developers. As of the end of June 2006, it had 16 projects under development. In December 2006, it outbid other six developers, including Beijing Capital Land (2868 HK, HK$3.43, NR) and China Resources (1109 HK, HK$8.09, NR), and bought a 0.31m sq.m GFA site in Beijing's Chaoyang district for about RMB1.8b, representing a 58.0% premium over the opening bid of RMB1.12b. SORED reported a two-year earnings CAGR of 105.9% between FY12/03A and FY12/05A. Its earnings for 1H FY12/06A surged five-fold to RMB164.2m. Its net asset value (NAV) was reported at RMB1,493.0m as of June 2006. In 1H FY12/06A, the company contributed HK$33.1m to the group, against a loss of HK$8.0m in the year-earlier period, thanks to the valuation surpluses recognized. We expect SORED's contribution to increase in FY12/06F, because of: 1) its higher stake in SORED (increased in October 2006 to 44% from 20.0% for HK$385.3m, representing a 10.3% premium over SORED's NAV); 2) increase in GFA sold. The group sold about 0.32m sq.m GFA in 1H FY12/06A, equivalent to 86.5% of the GFA sold in FY12/05A and 3) higher property prices in China.

Unleashing the hidden value. SORED has brought in three strategic investors, including the private equity investing arm of Standard Chartered (2888 HK, HK$224.20, NR), which has invested US$35.0m in the company. According to media reports, the other two are Morgan Stanley and Merrill Lynch. SORED is expected to list on the HKEX between 3Q and 4Q 2007 to raise HK$3.0b-4.0b, with Morgan Stanley and Goldman Sachs acting as sponsors. The listing should unleash the group's hidden value.

Capacity expansion to drive growth. Currently, the group manufactures and sells coating products through its 63.1%-owned joint venture with the renowned Japanese coating manufacturer Kansai and its 50.0%-owned JV with Jotun Group, one of the world's top three marine paint producers. The COSCO Kansai's coating plant in

Tianjin has a production capacity of 63,000 t.p.a and the COSCO Jotun plant in Guangzhou 14,300 t.p.a.. Due to the seasonal weakness in the container market between 2H 2005 and 1H 2006, its coating division earnings plunged 48.0% to HK$42.0m in FY12/05A and 32.0% to HK$30.0m in 1H FY12/06A. The group increased the price of all the categories of paint products four times last year, with the price of container paint up 30.0%, and marine and anti-corrosion paint both up 10.0%. Besides, since the crude oil price peaked in July last year, its gross profit margin should have improved. We expect the division's growth momentum to pick up in 2H FY12/06F, due to capacity expansion and higher demand for containers globally. COSCO Kansai's new paint production plant in Zhuhai with a production capacity of 24,000 t.p.a. will come on stream in July 2007. The capacity at the new plant can be expanded to as much as 32,000 t.p.a..

Demand for coating to increase. According to AXS-Alphaliner's estimations, the size of the global container fleet will increase at a four-year CAGR of 12.9% between 2006 and 2010, in terms of TEU (twenty-foot equivalent units). The global container fleet size will expand 10.7% YoY to 4,006 vessels in 2007 and 11.4% YoY to 4,464 in 2008, which will spur demand for containers and ultimately for container paint. The production volume of containers is forecast to increase 10.0% YoY to 2.5m TEU this year boosting demand for container coating products. Impact Marketing Consultants estimated that demand for container coating would increase at 30.0% this year. Growth in the group's anti-corrosion paint would be strong in our view, on the back of the robust fixed assets investments in China. Anti-corrosion coating products command the highest gross profit margin at 33.0% among the group's coating products. Worth to note is that the group is one of the major producers of anti-corrosion paint for nuclear power plants in China.

Booming ship building industry. Commission income from vessel trading is collected and booked in four phases up to the delivery of vessels to the owner. In 1H FY12/06A, the group's vessel trading volume doubled to 3.14m DWT. The group's order book on hand is strong thanks to addition and replacement demand for vessels of all kinds. According to Maxmart, order books for containerships reached 427 for 2007, 443 for 2008 and 278 for 2009. The phasing out of old single-hull tankers by 2010 as mandated by the International Maritime Organization will result in more new builds as well. Another drivers are the price and size of ships. Recently, liner operators have been placing orders for larger vessels, which together with the higher price of steel and demand for new vessels, drove the prices up. The group will realize more commission income as the orders are getting larger in value. China is the world's third largest ship building country and ultimately will surpass Korea and Japan, as it continues to advance technologically and expand its capacity. With the strong parental back up, the group is set to benefit from the country's booming ship building industry.

Insurance foray into China. The group's insurance brokerage division provides services mainly to its parent's fleet. Before 2006, it was not allowed to provide marine insurance to vessels flying China's flag, as it was not a Chinese company, and therefore it provided insurance brokerage services to less than one-third of the COSCO's fleet. Following the Chinese government's liberalization of the insurance industry, the group can provide insurance brokerage service to the entire COSCO fleet. It teamed up with Shenzhen Ocean, a non wholly-owned subsidiary of the COSCO Group, to form a JV, Shenzhen COSCO Insurance Broker Ltd. The JV aims to provide insurance brokerage services to the entire COSCO fleet as well as other ships flying China's flag. Growth potential of the JV is tremendous, given the aggressive expansion in the Chinese fleet. However, since the JV is quite new and most of the current insurance policies will not expire until the end this year, it will take time to see a meaningful contribution to the group.

More asset injections from parent expected. As 1,148 container ships and 799 bulk carriers would be delivered in between 2007 and 2009, demand for parts is expected to be strong. Order values will also rise, as most of the new vessels will need advanced and sophisticated parts and equipment. Nevertheless, due to geographical constraints, the group can provide only limited services to its parent and other fleets. To broaden its sales network and increase trading volume, we expect it to acquire more trading related assets from parent.