China COSCO

Outlook remains challenging

Key points:

- The world's sixth container shipper (no. 1 in China) and the largest dry bulk carrier
- Low revenue/cargo visibility in the sector with any rebound far off
- BDI at an all time low of 763pts and spot dry bulk rates down at US$2,773/day (from a high of US$233,988 in Jun 2008)
- Rates on the European route down about 20.0% YoY during contract renewals in 3Q
- Low chances of consolidation in the dry bulk industry
- We are negative on the shipping sector in the absence of early economic rebound prospects and low revenue/cargo visibility of key shipping players

Company background. Tianjin-based China COSCO is China's biggest shipping conglomerate and one of the global leading providers of integrated container shipping services. It provides container shipping services (1H FY12/08A: 33.3% of sales), dry bulk shipping (55.8%), logistics services (9.9%), container terminal services (0.3%), container leasing (0.5%). Its business is very sensitive to international and China trade. The company, listed in Hong Kong in 2005, is 54.5%-owned (53.7% A-shares and 0.8% H-shares) by COSCO Group. China COSCO wholly owns COSCO Container Lines (container shipping and freight forwarding), COSCO Bulk, COSCO Qingdao, COSCO HK Shipping, COSCO Shenzhen, and 51.0% of COSCO Logistics (third-party logistics and shipping agency) and COSCO Pacific (terminals, container leasing and manufacturing).

Four main shipping routes. The company offers shipping services on four main trade container routes. In 1H FY12/08A, the Asia-USA route accounted for 38.1% of the total, Asia-Europe 34.2%, inter-Asia 16.0% and China 6.3%.

Leader in container and dry bulk shipping. China COSCO is the world's 6th container shipper (largest in China) and the largest dry bulk carrier. As of 3Q FY12/08A, China COSCO had a fleet of 146 container vessels, with a capacity of 493,965 TEUs (54.0% >5000 TEU vessels). It expects its capacity to reach 502,092 TEUs in FY12/08 and 562,503 TEUs in FY12/09. The company operates 462 dry bulk vessels, with a capacity of 36.1m DWT, including 206 self-owned and 256 chartered. This mix allows the company to quickly adjust its capacity to market demand. Despite being the largest dry bulk shipper, China COSCO has only around 8.0% of the market, suggesting that the industry is extremely fragmented. About 49% of its charter capacity will expire in the next 12 months, which should improve its cost structure, as vessel rentals account for ~70.0% of its operating expenses.

BDI - core global activity indicator. The Baltic Dry Index (BDI) is a daily average of shipping charges for raw material commodities. It represents the cost paid by an end user to have raw materials transported across seas and is a good indicator of global economic activities, as it factors in: 1) commodity demand; 2) market

SBI E2-Capital

Not Rated

China Shipping

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Stock data

Price	**HK$4.46**
Target price	n/a
12 mth range	HK$2.5-28.4
Market cap.	US$ 11,553.2m
Daily t/o, 3 mth	US$50.9m
Free float %	60.6%
Ticker	1919.HK/1919 HK

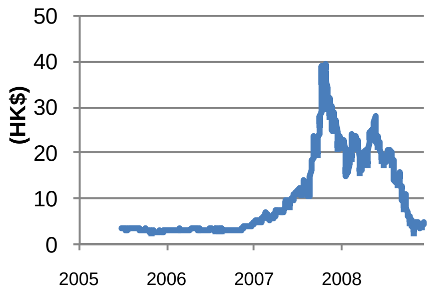
Financial summary

Year to Dec	05A	06A	07A
Turnover (HK$m)	39,165.7	78,856.3	107,998.5
Net Profit (HK$m)	5,582.1	8,292.4	19.477.9
EPS (HK$m)	0.946	0.906	2.182
EPS △%	NA	-4.2	140.8
P/E (x)	3.28	4.88	9.24
P/B (x)	1.12	0.91	4.42
EV/EBITDA (x)	4.27	3.89	8.67
Yield (%)	3.65	1.77	0.89
ROE (%)	13.70	12.32	29.51
ROCE (%)	30.74	27.95	43.25
N. Gear. (%)	86.4	54.8	41.6

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-1.8	-48.6	-66.2
Actual price changes (%)	-10.6	-65.2	-81.2
	08F	**09F**	**10F**
Consensus EPS (HK$)	2.363	1.258	0.842
Previous forecasts (HK$m)	NA	NA	NA
Previous EPS (HK$)	NA	NA	NA

Price Chart



sentiment in forecasting demand for raw materials; 3) oil prices; 4) seasonality; 5) shipping lane bottlenecks; 5) ports congestion. The weakening commodity demand since Jun 2008 has brought the BDI to its 20-year low of 763pts (26 Nov), from the all time high of 11,793pts (10 May), a drop of 93.5% in just over six months.

Reasons behind the drop. The BDI plunged because demand for dry bulk shipping services dried up due to the falling steel demand as economies around the world (especially in the US and Europe) started slowing down and various industries stopped importing raw materials, mainly from China. According to the company, this sudden shrinkage has also led to the cancellation of an estimated 30.0% of the worldwide dry bulk vessel production. The BDI was under further pressure as index speculators unwound their positions and long-term contract holders failed to honor previously agreed shipping rates.

Dry bulk shipping outlook murky. The spot rate for capsized is down 98.7% to US$2,773/day (26 Nov) from the record high of US$233,988/day (5 Jun). Management indicated that at current rates, most operators are running at a loss and many are scrambling for cargo volumes. Operators are estimated to have typically laid up around 10-15% of their fleets. Despite this, China COSCO does not expect much consolidation as: 1) many operations are family businesses, 2) demand for chartered services remains strong and 3) due diligence on contracts during acquisitions is difficult. Management suggests that if China can sustain a GDP growth of above 8.0% in 2009, the BDI may rebound to around 3,000pts. As a general rule, the breakeven point for charter operators is around 4,000pts and owners around 1,500pts. Despite its large charter fleet, China COSCO has no intention to lay up its vessels.

Container shipping outlook also bleak. Container lines are facing: 1) heavy fixed costs and plunging shipping prices; 2) vessel under-utilization from low cargo volumes. This situation has been exacerbated over the past few years as container shippers have added larger vessels to leverage economies of scale. China COSCO has indicated that rates on its European route during the recent quarterly contract renewals in October were down more than 20.0% YoY and it expects rates in 1Q 2009 to decline around 30.0% YoY. On US routes, contracts are renewed yearly, usually in May, and we expect a similar gloomy trend.

Light credit risk for China COSCO. With net cash of RMB13.8b as of 3Q FY12/08A and 73.1% of its short-term loan repaid in 3Q FY12/08, the company's balance sheet is quite strong. It has relatively low FFA exposure as only around 10% of its dry bulk fleet is committed to FFA contracts. The company booked a net loss of RMB430.0m (investment gain of RMB1.9b vs fair value loss of RMB2.3b) on its FFAs < 1 year maturity due to the drop of the BDI spot rate as of 3QFY12/08, accounting for 2.0% of its net profit.

Competitive advantages. The group aims to become the global leading shipping services conglomerate and we expect asset injections from its parent and M&As. The company currently leverages on: 1) its unrivalled turnkey freight network in China; 2) over 40 years of shipping experience and a strong brand; 3) a portfolio of more than 30 long-term partnerships for dry-bulk shipping (incl. AnSteel and BaoSteel); 4) an extensive international network and 5) close relations with COSCO Group, which provides China COSCO with access to cargo demand, bulk oil supply and transfer labor.

Valuation. The counter is currently trading at HK$4.46, which represents an estimated consensus FY12/08F P/E of 1.67x and a P/B ratio of 0.78.

Table 1: Turnover by segment

Year to Dec (RMBm)	05A	06A	07A	1H 07A	1H 08A
Container shipping	31,959.8	39,989.7	45,766.3	20,920.5	23,497.5
Dry bulk shipping	5,872.1	26,823.8	48,648.3	20,925.0	39,332.4
Logistics		10,105.6	11,841.9	5,319.5	7,021.6
Container terminal	106.4	174.9	305	187.9	250.9
Container leasing	1,227.4	1,054.2	819.4	392.1	379.8
Other operations	0.0	708.072	617.4	0.0	0.0
Total	**39,165.7**	**78,856.3**	**107,998.5**	**47,745.0**	**70,482.1**

Source: Company Data

Table 2: China COSCO Consolidated Income Statement

Year to Dec (RMBm)	05A	06A	07A	1H 07A	1H 08A
Revenues	39,165.7	78,856.3	107,998.5	47,745.0	70,482.1
Cost of services	(30,591.1)	(66,682.1)	(83,402.7)	(38,359.3)	(51,157.6)
Gross profit	8,574.7	12,174.1	24,595.8	9,385.7	19,324.6
Other income	1,205.9	3,167.7	4,248.9	1,502.1	2,073.1
Selling, administrative and general expenses	(2,482.2)	(3,702.2)	(5,104.5)	(2,005.1)	(2,341.9)
Other expenses	(243.5)	(437.3)	(320.0)	(254.3)	(107.0)
Share reform	0.0	(439.7)	419.6	82.0	0.0
Operating profit	7,054.9	10,762.5	23,839.8	8,710.4	18,948.8
Finance income/(costs)	(868.4)	(826,2)	(564.3)	(376.0)	0.5
Operating profit after finance income/costs	6,186.5	9,936.3	23,275.6	8,334.9	18,949.3
Profit on disposal of an associate	0.0	0.0	690.0	0.0	0.0
Share of profits less losses of:	0.0	0.0	0.0	0.0	0.0
jointly controlled entities	601.9	673.4	955.7	351.1	431.2
associates	661.9	873.4	1,005.8	508.2	372.5
Profit before income tax expenses	**7,450.3**	**11,483.1**	**25,927.0**	**9,194.3**	**19,752.9**
Income tax expenses	(651.3)	(2,008.6)	(4,721.4)	(1,293.2)	(3,896.3)
Profit for the period	**6,798.9**	**9,474.6**	**21,205.7**	**7,901.1**	**15,856.7**
Attributable to:					
Equity holders of the Company	5,450.8	8,292.4	19,477.9	7,227.7	15,122.2
Minority interests	1,348.1	1,182.1	1,727.7	673.4	734.4
Distribution	3,893.4	6,323.7	39,072.3	3,735.6	9.9
Dividends	798.2	1,489.1	1,804.4	0.0	0.0
Basic Earnings per share	1.062	1.042	2.182	0.898	1.480
Diluted Earnings per share	1.055	1.042	2.182	0.898	1.480

Source: Company Data

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