

## Mixed outlook

## China Energy Logistic

### TSC Offshore (8149 HK, HK\$2.25)

### HOLD (downgraded from STRONG BUY)

**Profit warning.** TSC Offshore Group, formerly known as EMER International, issued a profit warning for FY12/07F. The company said that due to the appreciation of the Renminbi against the US dollar and increasing raw material and staff costs, its FY12/07F net profit may decline YoY. Further, revenue generated from turnkey packages will not be booked in FY12/07F.

**Table 1: QoQ comparison**

Year to Dec	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Turnover (RMBm)	20.6	75.4	47.8	72.7	57.5	44.9	71.1
Gross profit (RMBm)	8.8	33.7	19.7	34.9	24.4	20.7	25.9
GP (%)	42.6	44.7	41.2	48.0	42.4	46.1	36.4
Operating profit (RMBm)	(4.5)	19.8	6.9	16.6	9.4	5.3	9.1
OP (%)	na	26.3	14.4	22.8	16.4	11.7	12.9
Net profit (RMBm)	(4.1)	19.8	6.5	12.0	8.0	4.7	7.2

Source: Company

**Margin squeeze.** Revenue increased 179.7% YoY in 1Q FY12/07F, declined 40.5% YoY in 2Q and rose 48.6% YoY in 3Q. In the first nine months of 2007, it increased 20.7% YoY to RMB173.4m, implying that sales were still expanding. The headline gross margin for FY12/06A was 44.8% and TSC was able to maintain its blended margin above 40.0% in 1Q and 2Q FY12/07F. In 3Q, its blended margin narrowed to 36.4% from 41.2% in 3Q FY12/06A, implying increasing COGS due to higher steel and labor costs. China's average steel plate price rose 31.0% YoY in 3Q07 and 47.3% YoY in 4Q07. We expect the company's blended margin to shrink further in 4Q07.

**Operating margin narrows.** We believe a sharp increase in SG&A costs will also undermine net profit. TSC's operating margin narrowed 14.5pcp in 2Q and 1.6pcp in 3Q. In the first nine months of FY12/07F, selling and distribution expenses increased 25.4% YoY to RMB14.7m and administrative expenses 23.0% to RMB37.6m. We expect full-year expenses to be boosted by costs related to the acquisition of AIM-listed Global Marine Energy in 4Q, rising staff costs due to a shortage of professionals in the global offshore E&P industry and increasing R&D expenses.

**Income booking delay.** The company secured a turnkey package contract worth RMB828.0m in FY12/07F. Previously, we projected revenue from the contract at RMB50.0m and gross profit at RMB5.0m. However, under Hong Kong's Financial Reporting Standards, the company will not be able to book it in FY12/07F results.

**Wild card - foreign exchange.** The US dollar depreciated 6.5% YoY against the Renminbi in 2007, which may result in exchange losses.

**Changes in FY12/07F estimates.** In the first nine months of FY12/07, TSC reported net profit of RMB19.9m. We have slashed our net profit estimates by 82.4% to RMB7.4m for FY12/07F after: 1) lifting selling expense estimate by 13.2% to RMB16.2m; 2) lifting administrative expense estimate by 51.6% to RMB69.7m; 3) including an exchange loss of RMB16.7m; 4) cutting revenue estimate 8.7% to RMB281.0m (on deferred income from the turnkey package). We are revising our earnings forecasts for FY12/08F and beyond.

**Downgrade to HOLD.** The oilfield equipment sector is trading at one-year forward P/E of 12.4x and two-year forward P/E of 10.7x. The company's FY12/08F outlook is mixed. Revenue is expected to jump 289.3% YoY to

RMB1,046.6m, should the RMB710.0m from the turnkey package be recognized. However, as the company's acquisition target, Global Marine Energy, had negative equity of £0.34m as of end-Sep 2007. Since charges related to the acquisition and the impact on TSC cannot be estimated at this juncture, we downgrade the counter to HOLD from STRONG BUY and will re-visit our earnings forecasts after TSC's final results.

**Table 2: Oilfield equipment providers**

Company name	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
T-3 Energy Services	TTES US	Dec	USD	501.1	12.9	10.9
CARBO Ceramics	CRR US	Dec	USD	879.3	15.4	12.9
National Oilwell Varco	NOV US	Dec	USD	19,873.6	12.0	10.4
Gulf Island Fabrication	GIFI US	Dec	USD	381.0	10.4	9.2
Dril-Quip	DRQ US	Dec	USD	1,829.0	14.8	12.9
NATCO Group	NTG US	Dec	USD	830.9	15.5	13.3
FMC Technologies	FTI US	Dec	USD	7,187.7	19.1	16.2
Grant Prideco	GRP US	Dec	USD	5,961.4	10.7	9.2
Dresser-Rand Group	DRC US	Dec	USD	2,457.2	14.2	11.2
Complete Production Services	CPX US	Dec	USD	1,452.1	9.4	8.2
Vallourec	VK FP	Dec	EUR	5,013.2	8.9	8.7
Scomi Group	SGB MK	Dec	MYR	2,621.3	6.3	5.2
R H Energy	RHE SP	Dec	SGD	74.6	6.9	4.9
KS Energy Services	KST SP	Dec	SGD	506.9	4.7	4.0
<i>Average</i>					<i>12.4</i>	<i>10.7</i>

Source: Bloomberg

**Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the lead placing agent for TSC Offshore Group (formerly known as EMER International Group) in July 2007.**