Corporate Snippet

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Low visibility

China Energy Logistics

TSC Offshore (8149 HK, HK$2.32) HOLD (unchanged)

Better-than-expected results due to change in presentation currency. TSC Offshore Group saw its net profit dropped 18.5% YoY to US$3.5m (RMB24.6m). Previously, we slashed its FY12/07A earnings forecasts by 82.4% to RMB7.4m. The major difference between our previous projection and actual results was attributable to the gain/loss in foreign exchange. Previously, we projected the group to incur a loss in foreign exchange of RMB16.7m. Since the group changed its presentation currency to USD from RMB, no gain or loss arising from the foreign exchange had been incurred by the group. As 61.8% of the group's sales were generated outside, it was allowed to adopt USD as its presentation currency.

Table 1: QoQ comparison

Year to Dec	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07
Turnover (RMBm)	20.6	75.4	47.8	72.7	57.5	44.9	71.1	67.5
Gross profit (RMBm)	8.8	33.7	19.7	34.9	24.4	20.7	25.9	26.1
GP (%)	*42.6*	*44.7*	*41.2*	*48*	*42.4*	*46.1*	*36.4*	38.7
Operating profit (RMBm)	(4.5)	19.8	6.9	16.6	9.4	5.3	9.1	3.8
OP (%)	*na*	*26.3*	*14.4*	*22.8*	*16.4*	*11.7*	*12.9*	5.7
Net profit (RMBm)	(4.1)	19.8	6.5	12	8	4.7	7.2	4.6

Source: Company

Gross margin under pressure. Its turnover reached US$34.3m (or RMB241.0m) during the period under review, represents an annual growth rate of 27.0%. However, its turnover for 4Q FY12/07A actually dropped 7.1% YoY to RMB67.5m. The group's blended margin narrowed to 40.3% from 44.7% for FY12/06A. However, its gross profit margin for 4Q FY12/07A improved slightly to 38.7% from 36.4% in 3Q FY12/07A. Its blended margin has remained below 40.0% since 3Q FY12/07A. High raw material and production input costs will continue to put pressure on the group's gross margin. Further, the group is offering cantilever and drilling turnkey package to offshore rig builders and the gross margin of the business is estimated at approximately 10.0%. Three sets of turnkey package will be delivered in September 2008. Thus, we expect the rig turnkey solution division will be a drag to the group's blended margin in FY12/08F and FY12/09F.

Increase in staff costs boosted up SG&A expenses. The group's operating margin squeezed to 11.5% from 18.0% during the period, due to the surge in SG&A expenses. Its administrative expenses increased 38.5% YoY to approximately US$8.0m, representing 23.3% of the group's turnover, compared with 21.3% in FY12/06A. The increase in administrative expenses was due to increase in staff costs. Besides, selling and distribution surged 43.2% YoY to approximately US$2.6m, representing 7.4% of the group's sales compared with 6.6% in FY12/06A. The sharp increase in selling and distribution expenses was attributable to the increase in number of sales engineers, marketing expenses as well as delivery costs.

Financial position. After two find raising exercises in last year, the group was in a net cash position of US$41.7m as of the end of December 2007,. The group raised HK$45.0m (or US$5.8m) by placing 24.3m new shares at HK$1.88 each in April 2007. In July 2007, the group placed approximately 53.5m shares at HK$5.8 each and raised HK$300.0m (or US$38.4m). Further, the group received an advance payments in relation to the provision of the turnkey package of approximately US$27.0m. Its receivable turnover days increased substantially to 211 days as of the end of FY12/07A from 122 days as of the end of FY12/06A. On the other hand, the group's payable turnover days increased from 63 days as of the end of FY12/06A to 236 days as of the end of FY12/07A. The group's receivable and payable increased 143.5% YoY and 418.1% YoY, respectively, to US$28.2m and US$37.3m. The substantial increase in its debtors and creditors was due to the provision of offshore turnkey solution. The lead time of the turnkey package is longer than 12 months, by estimation.

Sales breakdown. Sales of rig electrical control system, other rig equipment, expendables and supplies and consultancy service fee income accounted for 34.7%, 22.5%, 40.6% and 2.1%, respectively of the group's total revenue. Sales derived from China, North America and other countries include Asia, Europe and Russia accounted for 38.2%, 48.2% and 13.6%, respectively of the group's turnover,

Rig turnkey solution. No revenue was recognized from the provision of rig turnkey solution. The group was awarded 6 contracts in July 2007 for providing cantilever and drilling System Packages for three ship sets jack-up rigs to be built by Yantai Raffles Shipyard – the biggest offshore rig builder in China. The total contract value was approximately RMB828 million. The group is due to deliver three packages to Yantai Raffles Shipyard in September 2008, November 2008 and January 2009 respectively. Gross margin of the contracts is estimated to be 10.0%. We project that the group would book RMB710.0m income generated from the contract.

Rig products and technology-more new product to be launched. The group's rig products and technology division is engaged in the provision of capital equipment of rig electrical control system, mud pump, solid control and jacking control system. Sales derived from the division increased 46.6% YoY to US$19.7m, thanks to the introduction of new products. The group sold 27 sets of rig electric control system in FY12/07A. It obtained order from an international client to develop four sets of jacking control system. Three sets were completed and passed ABS (American Bureau of Shipping Ship Classification) approval before delivery to that customer. The group also launched solid control systems upon the completion of acquisition of Highlights, a solid control system manufacturer. The group also delivered 90 sets of mud pumps to customers in North America and South America. On the R&D front, the group completed the development of new rig equipment for offshore rigs and it has received orders for those new products. The group completed the construction of a new factory for Xian production base and the workshop annex to Qingdao production base. Further, it also overhauled Highlight's workshop.

Oilfield expendable and supplies. Due to the price competition from other suppliers, turnover of the group's oilfield expendables and supplies increased modestly by 6.4% YoY only, to US$13.9m. The group's oilfield expendables and supplies division is operated by TSC (USA), which is responsible for sales and marketing in the USA, and TSC (QD) is responsible for the manufacturing in China.

GME is likely to be a short-term drag. In December 2007, the group purchased approximately 21.0m shares of the AIM listed Global Marine Energy (GME) at 15.5 pence (approximately RMB2.2), representing 28.7% of the total issued share capital of GME. The group will acquire 35.8m more shares of GME at 16.0 pence each by the end of April 2008. Following the completion of the acquisition, the group would have 77.8% interests in GME. Total consideration of the acquisition is estimated at US$18.1m (or RMB127.1m). GME had negative equity of ￡0.34m as of end-Sep 2007. The charges related to the acquisition and the impact on the group cannot be estimated at this juncture, but it is likely to be EPS and shareholder's value dilutive in the short term. Nevertheless, the acquisition should be positive to the group's long term development. Via acquiring GME, the group can expand its product portfolio and gain access to new clientele.

Qualified opinion by auditor on treatment of associate. The group's auditor, KPMG, will soon issue its opinion on the accounting treatment of its 28.0%-owned associate Goldman Offshore. The group's investment in Goldman Offshore is stated at cost less impairment losses, while the auditor believes the equity method should be used. Goldman Offshore owns 25.0% interests in Freide & Goldman Group, a world-class offshore rig platform engineering and design house. Via Goldman Offshore, the group now owns 7.0% interests in Fredie & Goldman.

Valuation and recommendation. The oilfield equipment sector is trading at one-year forward P/E of 14.2x and two-year forward P/E of 12.2x. 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, charges related to the acquisition and the impact on TSC cannot be estimated at this juncture. In view of the company's mixed FY12/08F outlook, we reiterate our HOLD recommendation. We are revising our model, rating and valuation target.

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.