Cosco Corporation (S) Ltd
Gearing up for offshore

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Industry: Shipbuilding

Phillip Securities Research Pte Ltd

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Report type: Full Year Results

Company Overview
Cosco Corporation (S) Ltd has one of the largest ship repair, shipbuilding and offshore marine engineering operations in China. It owns a 51% stake in Cosco shipyard group.

- Results within expectations.
- Margins hit by higher labor, raw materials and 'learning curve' costs.
- Shipbuilding market remains challenging.
- Upgrade to reduce from Sell with revised target price of S$1.00.

What is the news?
Cosco reported FY11 revenue of S$4.2 bil. (+ 8% Y-Y) and net income of S$140mil. (-44% Y-Y). The fall in net profit was mainly due to lower dry bulk shipping income and higher operational costs (labor and raw material) in its shipyard businesses.

Income Statement (Extract) (S$'mn)	FY10	FY11	y-y (%)	Comments
Revenue	**3,861**	**4,163**	**7.8%**	**Higher contribution from shipbuilding & marine engineering**
EBITDA	599	469	-21.6%	Lower shipping profits, higher shipyard ops costs
EBIT	430	305	-29.1%	
Net Income	**249**	**140**	**-43.9%**	**Within expectations**

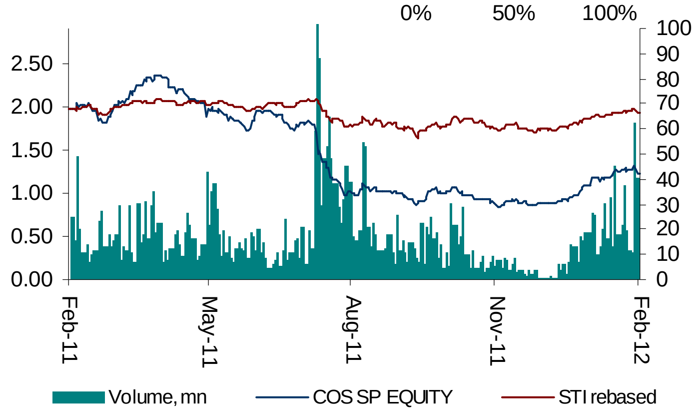
Source: Company, PSR

How do we view this?
Cosco's result for the year was within expectations as we already factored in weaker 4Q11 results on lower shipping profits, "learning curve costs' on the execution of new types of marine engineering contracts and higher labor costs.

Investment Actions?
It is highly likely that Cosco margins will remain low in FY12 and possibly into FY13 due to a combination of a weak shipping market and escalating operational costs. However, we opine that investors consider the possibility of Cosco emerging to be a formidable offshore rig builder in the future. We upgrade our target price for Cosco from $0.82 to $1.00 with a REDUCE call. Our target price of $1.00 is based on 16x FY12e EPS (from 14x FY12e EPS previously).

Cosco Corp (S) Ltd		
Rating	**4**	**Reduce**
- Previous Rating	*5*	*Sell*
Target Price (SGD)	**1.00**	
- Previous Target Price (SGD)	*0.82*	
Closing Price (SGD)	1.23	
Expected Capital Gains (%)	-18.7%	
Expected Dividend Yield (%)	2.0%	
Expected Total Return (%)	**-16.7%**	
Raw Beta (Past 2yrs weekly data)	2.18	
Market Cap. (USD mn / SGD mn)	2191 / 2754	
Enterprise Value (USD mn / SGD mn)	2987 / 3790	
3M Average Daily T/O (mn)	12.1	
52 week range (SGD)	0.83 - 2.39	
Closing Price in 52 week range		

0% 50% 100%



Major Shareholders	**(%)**
1 China Ocean Shipping Group	53.4
2. Temasek Holdings Pte Ltd	5.0
3. Sembcorp Marine Ltd	5.0

Key Financial Summary

FYE	**12/10**	**12/11**	**12/12F**	**12/13F**
Revenue (SGD mn)	3,861	4,163	3,920	3,528
Net Profit (SGD mn)	249	140	108	106
EPS (SGD)	0.11	0.06	0.05	0.05
P/E (X)	11.1	19.7	25.4	26.1
BVPS (SGD)	0.54	0.58	0.60	0.62
P/B (X)	2.3	2.1	2.1	2.0
DPS (SGD)	0.04	0.03	0.02	0.02
Div. Yield (%)	3.3%	2.4%	2.0%	2.0%

Source: Bloomberg, PSR est.
*All multiples & yields based on current market price

Valuation Method
P/E (16x FY12E)

Analyst
Nicholas Low,CFA
nicholaslowkc@phillip.com.sg
+65 6531 1535

Expected losses on construction contracts widens

Cosco's 4Q11 operating margins remained weak as it recognizes revenue on low value shipbuilding contracts and earns lower shipping profits (weak dry bulk freight rates). In addition, Cosco continues to experience significant cost pressures on three fronts 1) higher labor costs (6 to 10% higher), 2) higher raw material costs and 3) "learning curve" costs on new types of marine engineering projects (drillship, Letourneau jackups). As a result Cosco suffered S$75mil expected losses on construction contracts in 4Q11 (vs S$47mil loss in 3Q11).

Fig 1. Weak operating margins continue in 4Q11

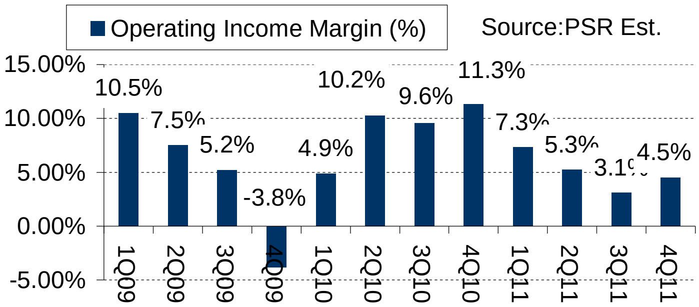
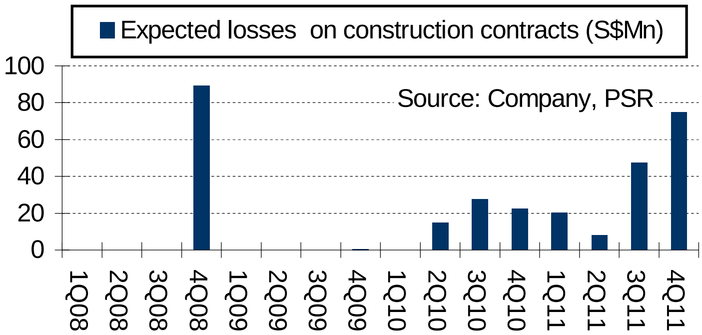


Fig 2. Expected losses on construction contracts escalates



Key Management Takeaways

Management guided that shipbuilding margins might turn negative in 2012 due to the low value of shipbuilding contracts secured in the past two years and a low level of shipbuilding once the 2010 order log has been cleared (unable to cover fixed costs). Management also estimated that labor costs rose 6 to 10% in 2011 and expects similar increase in 2012.Management also acknowledged the stiff competition it faces from other Chinese yards (who are desperate for work due to low shipbuilding orders) for offshore projects.

On a positive note, Cosco is in the midst on marketing its 4,000 to 5,000 teu containerships and hopes to clinch some orders soon. Going forward, the company intends to invest heavily in areas of research, design and development to improve design capability and strengthen its project management. To achieve this aim, it will employ another 200 workers to focus entirely on marine engineering R & D.

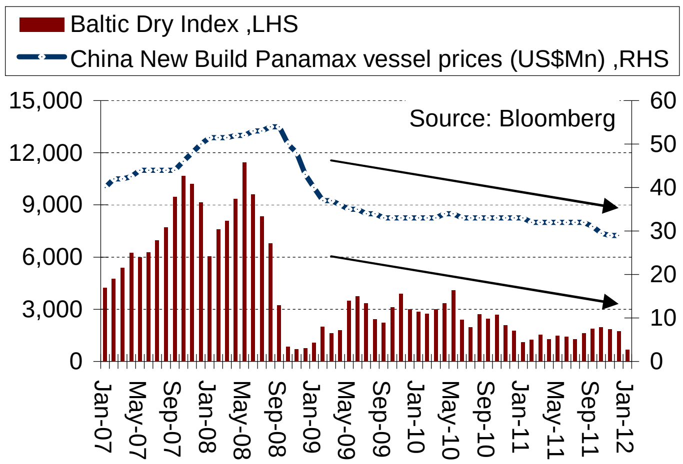
Update on Sevan Drilling

Sevan drilling reported in its 4Q11 results that it is looking to finance the installments that is due on delivery of two Sevan 650 drilling units currently being built at Cosco shipyard (80% on Rig no. 3 and 90% on Rig no. 4). Each rig cost US$526 million. It also entered into changed payment terms with Cosco shipyard group on Rig no. 4 to pay 5% on Feb 2012 (from 15% due 8 weeks prior steel cutting previously) and 90% upon delivery (from 80% upon delivery previously)
Its option with Cosco shipyard for the construction of another two rigs (Rig no.5 and Rig no.6) has also been extended to 10 Dec 2012.

Weak drybulk market to put pressure on rates and newbuild prices

The Baltic dry index currently stands at a near decade low of 704, reflecting a very weak dry bulk market. Prices for newbuild Panamax and Capesize vessels in China have also tumbled (See Fig.3). Looking forward, the outlook looks bleak with more newbuild dry bulk ships coming on-stream (Circa. 1/3rd of global dry bulk fleet currently under construction). Amidst tough market conditions, dry bulk carrier orders for Cosco have fallen rapidly, with only 2 dry bulk carriers ordered in 2011. Cosco will now have to rely on more offshore orders to fill its orderbook. Cosco's dry bulk shipping profits have also eroded rapidly in recent quarters due to poor freight rates.

Fig 3. Falling Baltic Dry Index and Chinese newbuild Panamax vessel price



A glimmer of hope?

While many challenges lay ahead for Cosco, we left the analyst briefing comforted by the knowledge that the company is doing all it can to improve its situation. For one, the company intends to focus more of its resources in research and development. That is a right step, in our view, to succeed in an industry where superior design, reliability and capability play a more important role than lower costs.

Second, it is noteworthy that Cosco has built/may be building two rather unique types of rigs that lay at the frontiers of marine engineering; They are the Sevan cylindrical semi-submersible drilling rig and the Dalian

Developer drillship. The Sevan driller is the world's first cylindrical ultra deepwater drilling rig and it was delivered by Cosco in 2009.The rig is currently chartered by Petrobras for its Brazilian drilling operations. Upstream recently reported that the Dalian developer drillship (that is currently under construction in Cosco shipyard) might be transformed into a multi-purpose drilling and spill response unit.

These two types of rigs are relatively new in the market and if both rigs are able to gain market acceptance, it will certainly improve Cosco's reputation and help it gain further offshore order wins in the future.

Fig 4. Cosco current orderbook stands at US$6.1bn

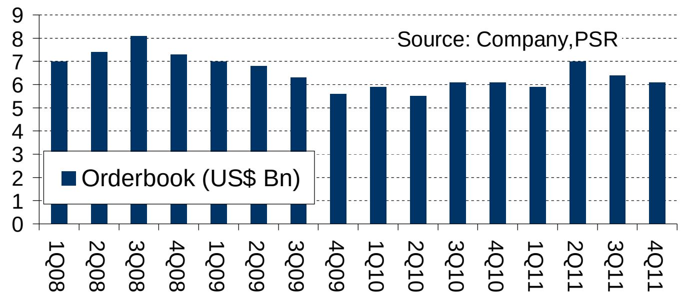


Fig 5. Orderbook Breakdown as of 23 Feb 2012

Type	No. of Units	Description
Shipbuilding	53	Bulk Carriers
	4	Special Purpose carriers
Offshore	1	Drillship
	3	Sevan Drilling units
	2	Semi-subs
	2	Jack ups
	1	Wind turbine installation vessel
	3	Tender rig
	2	Pipelay vessel
	1	Semi-sub barge

Source:Company,PSR

FYE Dec	FY09	FY10	FY11	FY12F	FY13F
Valuation Ratios					
P/E (X)		11.1	19.7	25.4	26.1
P/B (X)	2.5	2.3	2.1	2.1	2.0
EV/EBITDA (X), adj.	11.1	6.3	8.1	9.0	9.5
Dividend Yield (%)	2.4%	3.3%	2.4%	2.0%	2.0%
Per share data (SGD)					
EPS	0.05	0.11	0.06	0.05	0.05
DPS	0.03	0.04	0.03	0.02	0.02
BVPS	0.48	0.54	0.58	0.60	0.62
Growth & Margins (%)					
Growth					
Revenue	-16.6%	33.2%	7.8%	-5.8%	-10.0%
EBITDA	-37.6%	75.6%	-21.6%	-9.9%	-5.2%
EBIT	-55.9%	129.4%	-29.1%	-19.9%	-4.3%
Net Income	-67.2%	160.2%	-40.5%	-22.5%	-2.5%
Margins					
EBITDA margin	11.8%	15.5%	11.3%	10.8%	11.3%
EBIT margin	6.5%	11.1%	7.3%	6.2%	6.6%
Net Profit Margin	3.8%	6.4%	3.4%	2.8%	3.0%
Key Ratios					
ROE (%)	12.4%	31.4%	17.1%	12.5%	11.8%
ROA (%)	2.1%	5.7%	3.3%	2.3%	2.3%
Net Debt/(Cash)	(434)	125	581	(133)	256
Net Gearing (X)	Net Cash	7.0%	29.1%	Net Cash	11.6%
Income Statement (SGD mn)					
Revenue	**2,899**	**3,861**	**4,163**	**3,920**	**3,528**
EBITDA	**341**	**599**	**469**	**423**	**400**
Depreciation & Amortisation	(153)	(168)	(164)	(178)	(167)
EBIT	**187**	**430**	**305**	**244**	**234**
Net Finance (Expense)/Income	(9)	(28)	(18)	(45)	(40)
Other items	0	0	0	0	0
Associates & JVs	0	(0)	1	0	0
Profit Before Tax	**179**	**402**	**288**	**199**	**194**
Taxation	(41)	(43)	(74)	(34)	(33)
Profit After Tax	**110**	**249**	**140**	**108**	**106**
Non-controlling Interest	28	110	74	57	56
Net Income	**138**	**359**	**213**	**165**	**161**

Source: PSR

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FYE Dec	FY09	FY10	FY11	FY12F	FY13F
Balance Sheet (SGD mn)					
PPE	2,349	2,208	2,412	2,254	2,227
Intangibles	10	9	10	10	10
Investments in Associates	2	4	4	3	3
Investment Properties	12	15	14	14	14
Others	164	269	313	307	300
Total non-current assets	**2,536**	**2,505**	**2,754**	**2,588**	**2,554**
Inventories	678	518	491	473	390
Accounts Receivables	1,452	1,977	2,010	1,744	1,635
Construction contract WIP	199	183	148	168	115
Cash	1,549	867	1,585	2,299	1,811
Others	8	4	12	12	12
Total current assets	**3,886**	**3,549**	**4,247**	**4,695**	**3,962**
Total Assets	**6,422**	**6,053**	**7,001**	**7,283**	**6,516**
Short term loans	176	555	1,668	1,468	1,368
Accounts Payables	3,559	3,145	2,697	2,882	2,109
Others	135	118	131	131	131
Total current liabilities	**3,870**	**3,817**	**4,496**	**4,481**	**3,608**
Long term loans	939	437	498	698	698
Others	2	4	6	6	6
Total non-current liabilities	**941**	**441**	**504**	**704**	**704**
Non-controlling interest	527	596	699	761	821
Shareholder Equity	**1,084**	**1,199**	**1,301**	**1,338**	**1,384**

Cashflow Statements (SGD mn)					
CFO					
Net Profit	138	359	213	165	161
Adjustments	215	260	414	257	239
Cash from ops before WC changes	353	619	627	423	400
WC changes	(435)	(775)	(575)	457	(522)
Cash generated from ops	(82)	(156)	52	879	(121)
Taxes paid, net	(82)	(109)	(104)	(34)	(33)
Cashflow from ops	**(164)**	**(265)**	**(52)**	**846**	**(154)**
CFI					
CAPEX, net	(458)	(165)	(256)	(20)	(140)
Dividends received	1	1	0	1	1
Interest from bank deposits	41	20	26	19	23
Others	(0)	(4)	(5)	0	0
Cashflow from investments	**(416)**	**(148)**	**(235)**	**(0)**	**(116)**
CFF					
Share issuance	0	0	0	0	0
Loans, net of repayments	472	(61)	1,115	0	(100)
Dividends to minority interests	(34)	(2)	(7)	0	0
Dividends to shareholders	(157)	(67)	(90)	(67)	(55)
Others	15	(42)	(42)	(64)	(63)
Cashflow from financing	**296**	**(172)**	**977**	**(131)**	**(218)**
Net change in cash	**(285)**	**(586)**	**690**	**714**	**(489)**
Effects of exchange rates	(36)	(96)	30	0	0
CCE, end	**1,546**	**867**	**1,585**	**2,299**	**1,811**

Source: PSR

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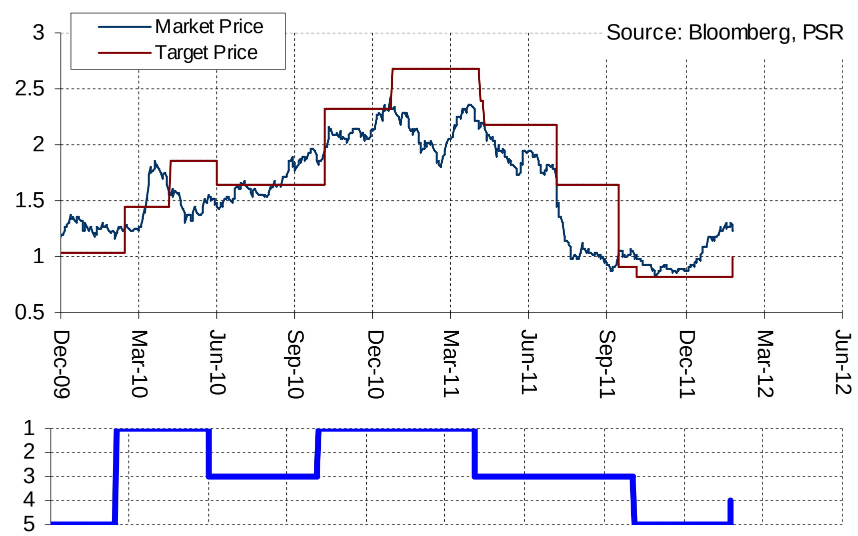
Ratings History



PSR Rating System

Total Returns	Recommendation	Rating
> +20%	Buy	1
+5% to +20%	Accumulate	2
-5% to +5%	Neutral	3
-5% to -20%	Reduce	4
< -20%	Sell	5

Remarks

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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Please contact Phillip Securities Research at [65 65311240] in respect of any matters arising from, or in connection with, this document.

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Contact Information (Singapore Research Team)

Chan Wai Chee
CEO, Research
Special Opportunities
+65 6531 1231
yebo@phillip.com.sg

Lee Kok Joo, CFA
Head of Research
S-Chips, Strategy
+65 6531 1685
leekj@phillip.com.sg

Joshua Tan
Strategist
+65 6531 1249
joshuatan@phillip.com.sg

Magdalene Choong
Investment Analyst
SG & US Financials, Gaming
+65 6531 1791
magdalenechoongss@phillip.com.sg

Go Choon Koay, Bryan
Investment Analyst
Property
+65 6531 1792
gock@phillip.com.sg

Derrick Heng
Investment Analyst
Transportation, Telecom.
+65 6531 1221
derrickhengch@phillip.com.sg

Nicholas Low, CFA
Investment Analyst
Commodities, Offshore & Marine
+65 6531 1535
nicholaslowkc@phillip.com.sg

Travis Seah
Investment Analyst
REITS
+65 6531 1229
travisseahhk@phillip.com.sg

Peter Lee
Research Assistant
General Enquiries
+65 6531 1240 (Phone)
+65 6336 7607 (Fax)
research@phillip.com.sg

Ken Ang
Investment Analyst
Financials
+65 6531 1793
kenangwy@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites**:** www.phillip.com.hk

JAPAN
PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website:www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co. Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel (86-21) 51699200
Fax (86-21) 63512940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005

AUSTRALIA
PhillipCapital Australia
Level 37, 530 Collins Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96298380
Fax (613) 96148309
Website: www.phillipcapital.com.au