Sector Update

China Oil Update

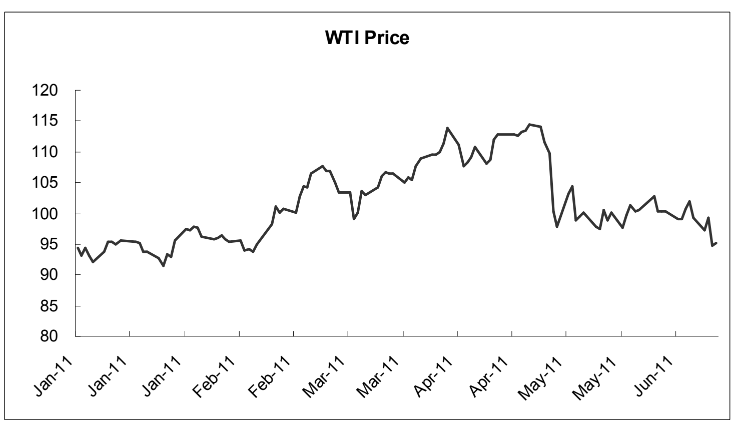
Phillip Securities Research Pte. Ltd.
23 June 2011

Economic Uncertainty Priced-in

- We adjust our 2011e oil price upward to US$95, reflecting the global economic uncertainty and China's slowdown in growth.
- China refinery maintenance may peak in early 3Q11; thus, reducing refinery outputs and exports. Even with the moderately declined oil prices, GRM is expected to remain negative in 2H11
- We continue favoring CNOOC as our top pick within the sector. We reiterate our 'BUY' rating with a target price to HK$22.3, which is based on the assumption of an average of oil price at US$90/bbl in 2011 and CAGR of 9.0% in the following 5-years.

Oil averaged at US$101/bbl ytd: question lies on if OPEC will increase its output to bring down the price

WTI averaged at US$101/bbl from the beginning of this year till June 16. Although prices have eased off since early May, we believe that the crude oil is still trading quite bullishly, whereas speculation plays an important part. According to NYMEX, the net long position has approximately doubled since 2010. Once the crude oil trades above its fundamental value, speculative activities from international managed funds tend to drive up the price as they start investing in crude oil rather than upstream companies.



Source: Bloomberg.com

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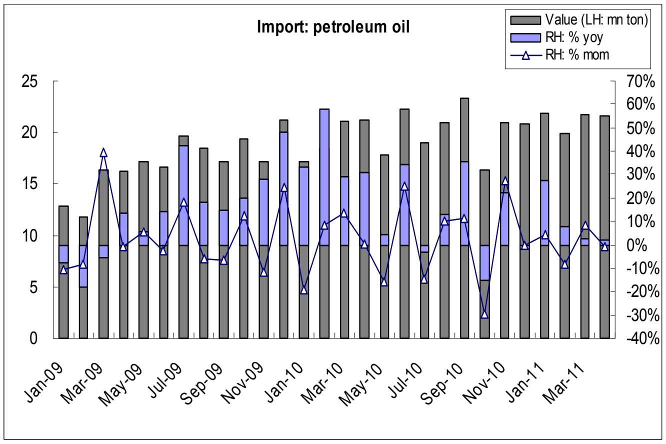
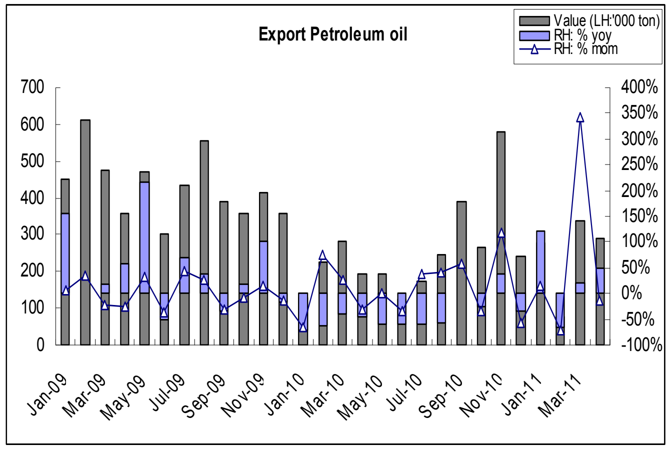
OPEC, specifically Saudi Arabia, repetitively asserts that they are comfortable with crude prices ranging between US$70-80/bbl. With that being said, according to the IEA, Saudi Arabia has increased its output from 8.2 to 8.9 million bbl/d in Feb and March, but since then cut back to January's level. OPEC claims that they still hold adequate spare capacity, approximately 3.6 million bbl/day. During OPEC's meeting in early June, they unexpectedly left the production level unchanged, and it was the first time in history that OPEC was unable to reach consensus. While Saudi Arabia strongly propones an increase in production in order to ease market's concern of the overpriced oil, other sub-strong countries in OPEC, lead by Iran, opposed the increase of production ceilings. With the unrest of Libya and Yemen, approximately 4% of the world's output was disrupted. Saudi Arabia said that they are ready to cover as much as 1.6 million bbl/d productions, but other OPEC nations said they are close to capacity. Another factor that causes the unchange in production, in our opinion, is the uncertain outlook of the global economy, lead by the US sagging employment rate and housing reports, China's slowdown of growth, and the potential of the Euro zone government default. The worsening of the global economy could dampen the global demand, or at least weaken producers and consumers sentiment.

China SOEs wouldn't get hurt much more since domestic oil prices didn't rock with the WTI in May.

China oil prices didn't rock with the WTI seen in May. While WTI hiked more than 20% from January to a May high, major China oil indicators increased less than 5%. China's oil prices are still trading at a discount compared to the regional index, ie. Singapore. We see that the downside oil prices has mostly priced in for PetroChina, Sinopec, and CNOOC.

Domestic oil and oil products demand have been on a slide with China's growth rate since October of last year. Total imports of petroleum oil dropped 0.59% mom and increased 1.76% yoy in April to 21.54 million bbl. Imports data in March was slightly better, up by 2.89% yoy and 8.65% mom. However, during the same period in 2010, imports were up by 58%, 29% and 31% yoy from February to April. Exports of petroleum oil fluctuated quite a bit in 2011. It was down by 66% yoy in February, followed by a gain of 20% yoy in March and 49% yoy in April. We believe the fluctuations were mainly due to the Chinese New Year effect. We see a potential oil demand risk in the near term, but we believe this is a short-term cut back while China is fighting inflation and tightening its budget. Demand re-boost is expected early next year.





Source: CEIC

<u>Refinery gross margin isn't likely to improve</u>

Chinese gross refining margin (GRM) is in the negative zone since the beginning of 2011. GRM is currently down to more than –US$10/bbl, and major improvement isn't expected. While oil prices retrieved, China is likely to cut the fuel prices; yet, refining margin isn't likely to improve significantly.

We are anticipating another hot and extreme weather summer, yet the government said that power shortage, if not extreme, is highly likely. We think a lot of companies will again turn to the diesel generators. However, refinery maintenance is likely to peak in the third quarter. The drop in capacity will lead to more imports to sustain the needs of diesel. In the mean time, we believe that both Sinopec and PetroChina will need to subsidize smaller refineries to ensure supply. This internal subsidy will hurt both companies to certain degrees.

<u>Company Profiles</u>

CNOOC: still our top pick with a target price of HK$22.3

- Production in 2011 is targeted to reach 355-365mmboe. US$8.77 billion CAPEX, up by 55% from 2010, will mainly be spent on development. Crude price is assumed to be US$82/bbl by the management, which is well below the WTI Ytd average of US$101/bbl.
- Fast growth rate is expected to carry from 2011 to 2015. CNOOC guides a CAGR of 6-10% for the following 5-years, which, in our opinion, would be in the upper end.
- Cost control stays competitive among global peers

Financial Highlights	2009A	2010A	2011E	2012E
Sales growth (%)	-16.50%	74.01%	15.50%	7.00%
Op profit growth (%)	-13.78%	77.07%	16.19%	1.30%
Eps growth (%)	-33.33%	83.33%	12.81%	1.39%
Op profit marin (%)	38.33%	39.01%	39.24%	37.15%
Net profit margin (%)	28.03%	29.72%	29.83%	28.27%
ROE (%)	17.65%	27.90%	25.90%	21.30%
ROA (%)	13.14%	16.59%	16.00%	14.10%
p/e (x)	16.00	13.01	12.05	11.80
p/b (x)	2.76	3.30	3.00	2.40
p/sales (x)	4.56	4.55	4.28	3.94
eps (RMB)	0.66	1.22	1.37	1.38

Source: Company data, Phillip Securities estimates

Sinopec: Neutral with a target price of HK$9.48

- Sinopec is aiming to increase its natural gas production from 12.5bcm in 2010 to 20-24bcm by 2015, representing a CAGR of 13.9%, which is the fastest segment growth within the Company.
- Although profitability improved better than expected in the refining division, GRM is still under pressure.
- Capacity of ethylene production is expected to expand to a high-end of 14 million tones per year by 2015, up by 53.8% increase from 2010.

Financial Highlights	2009A	2010A	2011E	2012E
Sales growth (%)	-10.04%	42.24%	5.30%	2.50%
Op profit growth (%)	244.39%	15.77%	11.66%	10.75%
Eps growth (%)	121.28%	13.70%	13.17%	10.85%
Op profit marin (%)	6.74%	5.49%	5.82%	6.29%
Net profit margin (%)	4.69%	3.75%	4.03%	4.36%
ROE (%)	17.50%	18.10%	18.46%	17.83%
ROA (%)	7.50%	7.84%	8.34%	8.72%
p/e (x)	9.2	7.9	7.2	6.6
p/b (x)	1.5	1.3	1.2	1.0
eps (RMB)	0.72	0.83	0.94	1.04

Source: Company data, Phillip Securities estimates

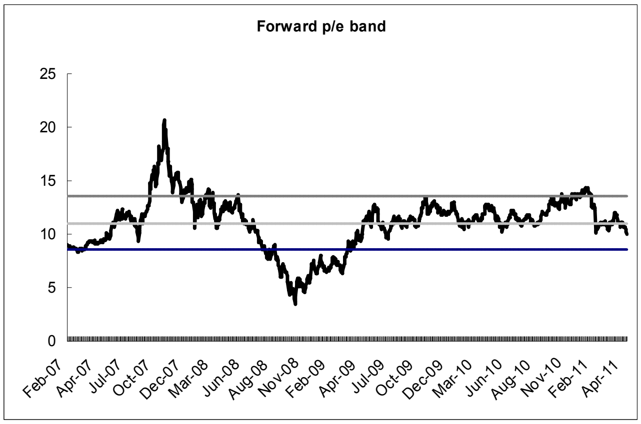
PetroChina: Underweight with a target price of HK$11.2

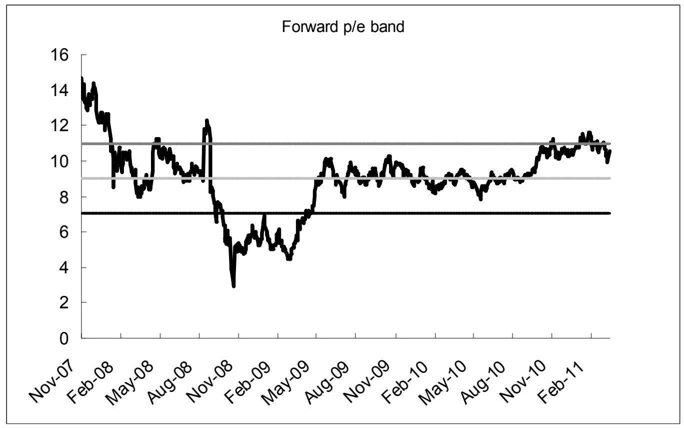
- We appreciate PetroChina's strong reserve position and natural gas expansion plan, but we find the Group lacks an aggressive growing force. We maintain our NEUTRAL rating with a 12-month target price of HK$11.2.
- Oil and gas volumes are expected to grow 3.3% and 10.4% in 2011, according to management's guidance.
- Much like Sinopec, the GRM of PetroChina isn't expected to improve in 2H11 either.

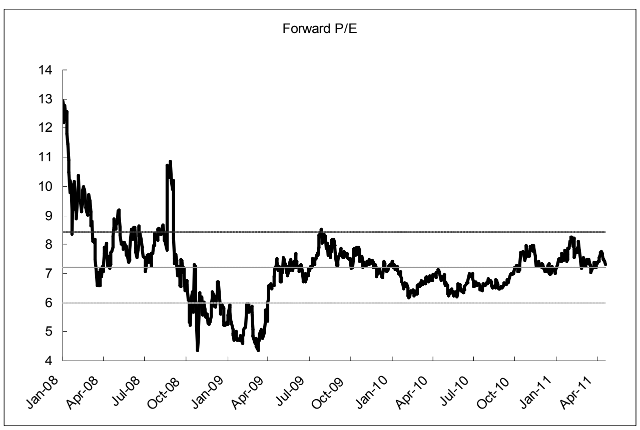
Financial Highlight	2009A	2010A	2011E	2012E
Sales growth (%)	-5.0%	43.8%	5.5%	7.5%
Op profit growth (%)	-10.1%	30.9%	15.4%	10.6%
Eps growth (%)	-11.1%	35.7%	10.5%	10.7%
Op profit margin (%)	14.1%	12.8%	14.0%	14.4%
Net profit margin (%)	10.5%	10.3%	10.8%	11.1%
ROE (%)	12.6	15.7	14.7	14.9
ROA (%)	10.1	9.0	8.8	8.4
p/e (x)	14.65	11.33	10.50	9.7
p/b (x)	1.77	1.68	1.70	1.6
p/sales (x)	1.47	1.08	1.27	1.26
eps (RMB)	0.56	0.76	0.84	0.93

Source: Company data, Phillip Securities estimates

Peer Comparison







Source: Bloomberg.com

	Current Mkt cap (RMB bn)	FY09 sales	FY10 sales growth	FY11e sales	FY12e sales growth	FY09 eps growth	FY10 eps growth	FY11 eps growth	FY12 eps growth
CNOOC	821.9	-16.5%	74.0%	15.5%	7.0%	-33.3%	83.3%	12.8%	1.4%
PetroChina	2030.0	-5.0%	43.8%	5.5%	7.5%	-11.1%	39.3%	5.3%	4.0%
SINOPEC	667.6	-6.9%	42.2%	5.3%	2.5%	11.6%	13.7%	13.2%	10.9%
Avg		-9.5%	53.3%	8.8%	5.7%	-10.9%	45.4%	10.4%	5.4%

	FY09 p/e	FY10e p/e	FY11e p/e	FY12e p/e	FY09 p/b	FY10e p/b	FY11e p/b	FY12e p/b
CNOOC	16.3	13.0	12.1	11.8	2.8	3.3	3.0	2.4
PetroChina	14.7	11.3	10.5	9.7	1.8	1.7	1.7	1.6
SINOPEC	8.6	7.9	7.2	6.6	1.7	1.3	1.2	1.0
Avg	13.2	10.7	9.9	9.4	2.1	2.1	2.0	1.7

	FY09 roe	FY10e roe	FY11e roe	FY12e roe	2009 Profit Margin	2010e Profit Margin	2011e Profit Margin	2012e Profit
CNOOC	17.7%	27.9%	25.9%	21.3%	28.0%	29.7%	29.8%	27.7%
PetroChina	12.6%	15.7%	16.2%	15.9%	10.5%	10.3%	10.8%	11.1%
SINOPEC	17.6%	18.1%	18.5%	17.8%	4.7%	5.5%	5.8%	6.3%
Avg	15.9%	20.6%	20.2%	18.3%	14.4%	15.2%	15.5%	15.0%

Source: Company data; Phillip Securities estimates

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