China / Hong Kong Company Guide

Cosco Shipping Energy Transportation

Bloomberg: 1138 HK EQUITY | Reuters: 1138.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

5 Oct 2020

BUY (Initiating Coverage)

Last Traded Price (30 Sep 2020): HK$3.20 **(HSI :** 23,459)

Price Target 12-mth: HK$4.00 (25% upside)

Analyst

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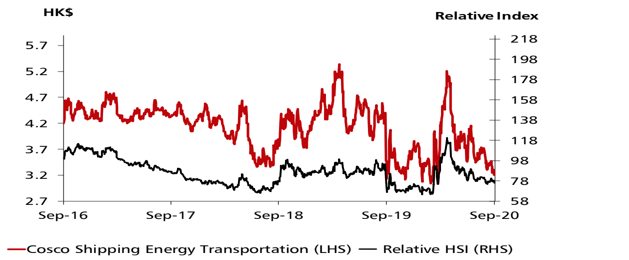
Price Relative



Forecasts and Valuation

FY Dec (RMBm)	**2018A**	**2019A**	**2020F**	**2021F**
Turnover	12,100	13,721	17,500	15,848
EBITDA	3,795	5,195	8,717	6,835
Pre-tax Profit	413	1,002	4,750	2,856
Net Profit	75	414	3,787	2,035
Net Pft (Pre Ex) (core profit)	97	417	3,812	2,035
Net Profit Gth (Pre-ex) (%)	(94.5)	330.6	814.1	(46.6)
EPS (RMB)	0.02	0.10	0.80	0.43
EPS (HK$)	0.02	0.12	0.91	0.49
Core EPS (RMB)	0.02	0.10	0.80	0.43
Core EPS (HK$)	0.03	0.12	0.91	0.49
EPS Gth (%)	(95.8)	454.2	674.8	(46.3)
Core EPS Gth (%)	(94.5)	330.6	673.9	(46.6)
DPS (HK$)	0.06	0.02	0.05	0.32
BV Per Share (HK$)	7.98	7.96	7.60	7.77
PE (X)	151.4	27.3	3.5	6.6
CorePE (X)	116.7	27.1	3.5	6.6
P/Cash Flow (X)	5.2	2.2	2.0	2.3
P/Free CF (X)	nm	2.9	6.6	5.0
EV/EBITDA (X)	10.5	7.3	6.0	7.9
Net Div Yield (%)	1.8	0.7	1.4	9.9
P/Book Value (X)	0.4	0.4	0.4	0.4
Net Debt/Equity (X)	0.9	0.9	0.8	0.7
ROAE(%)	0.3	1.5	12.7	6.3
Earnings Rev (%):			New	New
Consensus EPS (RMB)			0.73	0.53
Other Broker Recs:		B: 7	S: 0	H:0

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Deep value emerging

- Initiating coverage with BUY and HK$4.00 TP
- Undemanding valuation of 0.4x P/BV with 9-10%/5-6% div yield in FY20F/FY21F respectively.
- Tanker market should bottom out in 2H20; freight rates to trend higher in FY21F and drive re-rating
- Pivot to LNG transportation and limited new crude oil/oil product vessels bodes well for medium-term

Compelling valuation with improving prospects. After a short-lived 70% rally in Mar-Apr, Cosco Shipping Energy Transportation's (CSET)'s stock relinquished all its gains and is now near its 52-week low, mirroring the recent dive in freight rates. The current price level is a good entry point, in our view – CSET is trading at close to two standard deviations (SD) below its five-year mean on both a P/BV (0.4x) and EV/EBITDA (6.0x) basis, which is inconsistent with its earnings growth trajectory and normalised ROE of 6-7%. Furthermore, investors can enjoy an attractive dividend yield of 9-10% / 5-6% in FY20/21.

We expect a re-rating to be driven by tanker freight rates bottoming out on rising demand as we enter a seasonally stronger fourth quarter, with a more pronounced recovery in FY21F on the back of a more favourable supply-demand set up. CSET's medium-term prospects also appear promising, as the company continues to expand its LNG transportation division.

Valuation:

We value CSET on a P/BV peg of 0.5x (-1SD level) on FY20F book value to derive a TP of HK$4.00.

Key Risks to Our View:

i) Prolonged OPEC+ production cuts, ii) resurgence in COVID-19 cases globally, and iii) sluggish recovery in global oil demand

At A Glance

Issued Capital - H shares (m shs)	1,296
- Non H shrs (m shs)	3,467
H shs as a % of Total	27
Total Mkt Cap (HK$m/US$m)	32,119 / 4,144
Major Shareholders (%)	
China Shipping (Group) Co., Ltd.	44.3
Major H Shareholders (As % of H shares)	
GIC Private Limited	11.1
Eastspring Investments (Singapore) Limited	5.0
H Shares-Free Float (%)	83.9
3m Avg. Daily Val. (US$m)	5.27
GICS Industry: Industrials / Transportation	

DBS

Live more, Bank less

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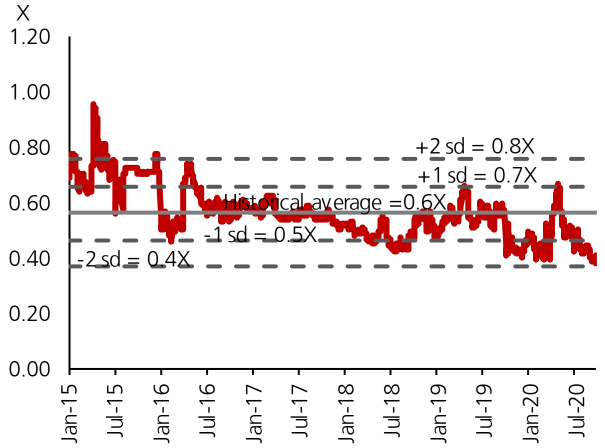
Investment Summary

Compelling valuation coupled with improving prospects. We initiate coverage on Cosco Shipping Energy Transportation (CSET) with a BUY call and TP of HK$4.00 for potential total return of c.30.0%. Our positive view hinges on: i) CSET's bargain valuation with the stock trading at its trough valuation, ii) attractive dividend yield of 9-10% in FY20F and 5-6% in FY21F, iii) improving sector fundamentals, and iv) promising medium-term earnings outlook.

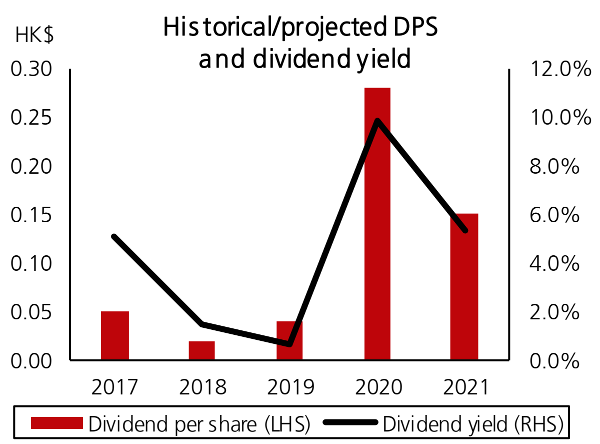
P/BV multiple at a historical low



Source: Clarksons, DBS HK

Stark disconnect between valuation and fundamentals. We believe that CSET's valuation is unjustifiably cheap, with its stock trading at close to 2 standard deviation (SD) below its five-year average, on both a P/BV (0.4x) and EV/EBITDA (6.0x) basis. A P/NAV analysis illustrates the same story, demonstrating that CSET is priced at >30% discount to its NAV. With the worst behind us in 2H20, we feel that current crisis level equity valuations do not accurately reflect CSET's earnings prospects. Additionally, the company's management expressed that they are committed to maintaining a 30-40% payout ratio, which should translate into alluring dividend yields of c.9.7% and 5.2% in FY20F and FY21F respectively.

Strong dividend yield should support CSET's share price

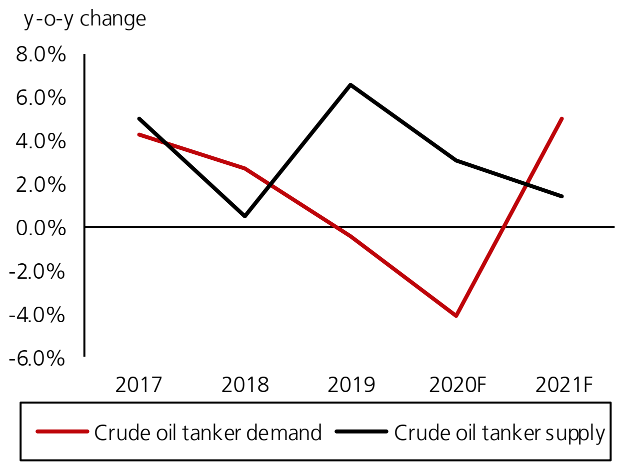


Source: Company, DBS HK

Freight rates should rebound in 1H21, as supply-demand dynamics turns more favourable after a challenging 2H20. Freight rates are likely to remain under pressure in the short-term as the unwinding of floating storage returns more oil tankers into the contracting pool, eclipsing a measured recovery in global crude oil transportation demand. In 2021F, however, we expect freight rates to rise more significantly, climbing back to the normalised range of US$30-40k/day from current levels of <US$20k/day, underpinned by the continued easing of global production cuts in the upstream sector and limited new crude oil/oil product tanker supply additions. Market conditions should be better for the oil products sector, given that a lower proportion of clean tankers are used for storage.

Sound medium-longer term prospects on the back of fleet additions and pivot to LNG transportation. A large proportion of new global refinery, and regasification terminal capacity is slated to come onstream in China and Asia over the next five years. This will provide an impetus for CSET to continue expanding its traditional crude oil/oil product tankers fleet, and accelerate the development of its LNG carrier fleet to ride on robust demand for natural gas in the region. As at June-2020, CSET's subsidiaries, JVs and associates had 18 oil tankers and 5 LNG carriers (3,010 dwt in total, 13% of existing fleet) under construction.

Supply & demand balance in the crude tanker market

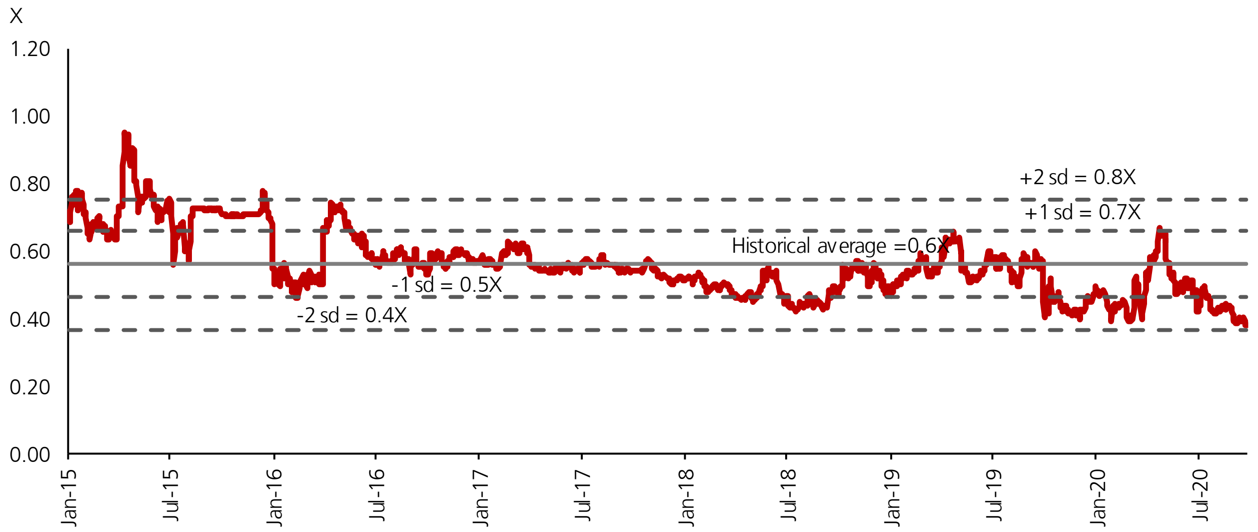


Source: Clarksons, DBS HK

Valuation & Peers Comparison

P/BV multiple unreasonably low at around -2 standard deviations (SD) below historical average. Despite CSET's softer earnings outlook for FY21F, we believe that the company's forward P/BV is not commensurate with the company's prospective return on equity profile. CSET is trading at almost 2SD below its 5-year average, which is too low when compared against its ROE of 6.3% (mid-cycle average ROE = 4.0%) in FY21F. The crude oil tanker sector should bottom in 2H20 and gradually progress towards the growth phase of the business cycle. **Hence, we believe that the company should be priced at the -1 SD level, which translates into a P/BV peg of 0.5x, and TP of HK$4.00.**

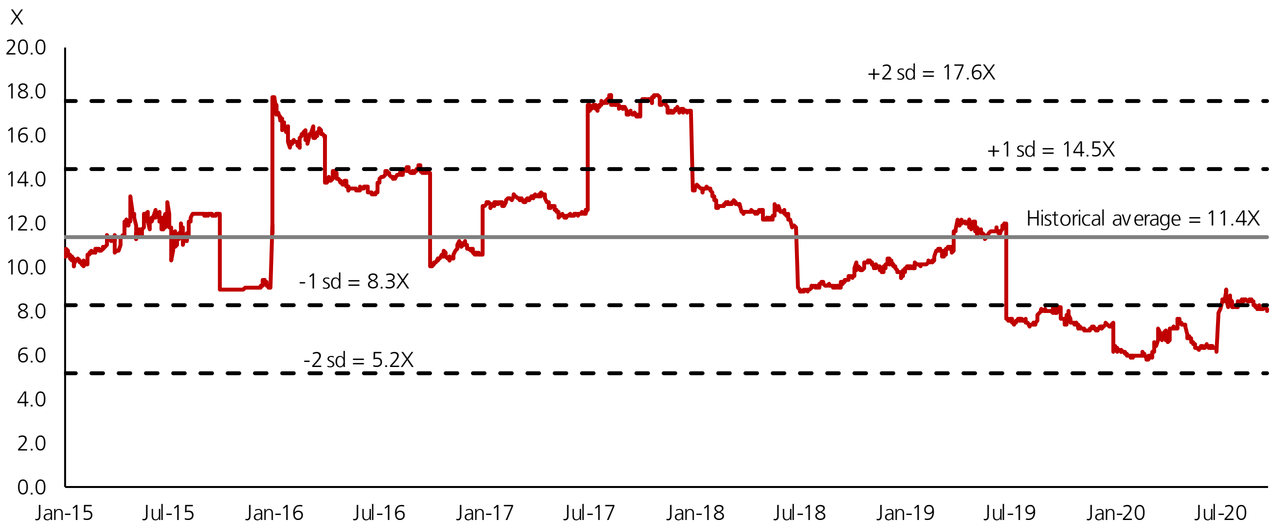
CSET's historical P/BV trading band



Source: Bloomberg Finance L.P., DBS HK

Cheap EV/forward EBITDA multiple also inconsistent with sound fundamentals. On a forward EV/EBITDA basis, CSET is also trading at more than 1SD below its 5-year average, with an EV/EBITDA (FY20F) multiple of 6.0x. Again, this is inconsistent with CSET's EBITDA growth prospects and return on capital trajectory.

CSET's historical EV/EBITDA trading band



Source: Bloomberg Finance L.P., DBS HK

P/NAV multiple depicts the same story. We adopt the P/NAV methodology to get a sense of what shareholders would receive in the event that CSET's assets were liquidated. Using second-hand prices quoted by Clarksons and other shipping brokers, adjusted for balance sheet items, we derive a TP of HK$4.20 based on 0.9x P/NAV multiple (against current 0.7x P/NAV). Given the cyclical nature of the sector, using current asset prices is fair in our view, as they are in line with mid-cycle values.

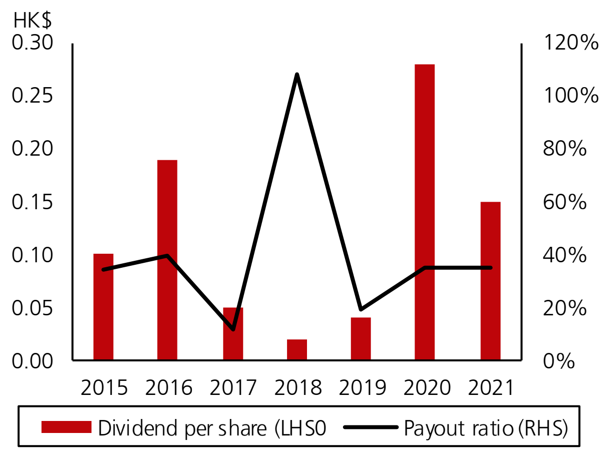
CSET's NAV Calculation

Crude oil tanker fleet				
	VLCC	Suezmax	Aframax	Panamax
Total tonnage (dwt)	13,415,158	635,447	223,447	1,361,075
Average age (years)	8.5	12.3	3.6	11.0
Total value (US$m)	**2,150.9**	**100.6**	**81.2**	**193.1**
Oil products tanker fleet				
	LR2	LR1	MR/Handy	Others
Total tonnage (dwt)	1,434,003	968,466	1,671,077	218,733
Average age (years)	8.6	7.0	11.2	11.3
Total value (US$m)	**682.3**	**418.9**	**591.7**	**92.9**
	Crude oil tankers	Oil product tankers	LNG Carriers	Other PPE
Total segment market value (US$m)	**2,526**	**1,786**	**1,078**	**431**
Total market value of fixed assets (RMB m)	**39,531**			
Add: JV & associates (RMB m)	6,197			
Add: non-cash working capital (RMB m)	94			
Less: net debt (RMB m)	(24,945)			
Less: minority interest (RMB m)	(1,293)			
Total net asset value (RMB m)	**19,585**			
Total equity value (HK$ m) [P/NAV peg = 0.9x]	**20,116**			
No. shares outstanding (millions)	4,763			
Price per share (HK$)	**4.20**			

Source: Company, Clarksons, DBS HK

Attractive dividend play. We anticipate CSET to generate adequate operating cash flows over the next few years to cover both its capital spending obligations and dividend distributions. While the company has no fixed dividend policy, (dividend payout ratio ranged between 11% to 108% in the past five years), the management stated that it intends to maintain a payout ratio of 30-40% as it seeks to reward shareholders. Assuming a payout ratio of 35%, we project DPS of RMB0.28/share in FY20F, and RMB0.15/share in FY21F, representing a forward dividend yield of about 9.0% and 5.0% respectively based on current share price levels.

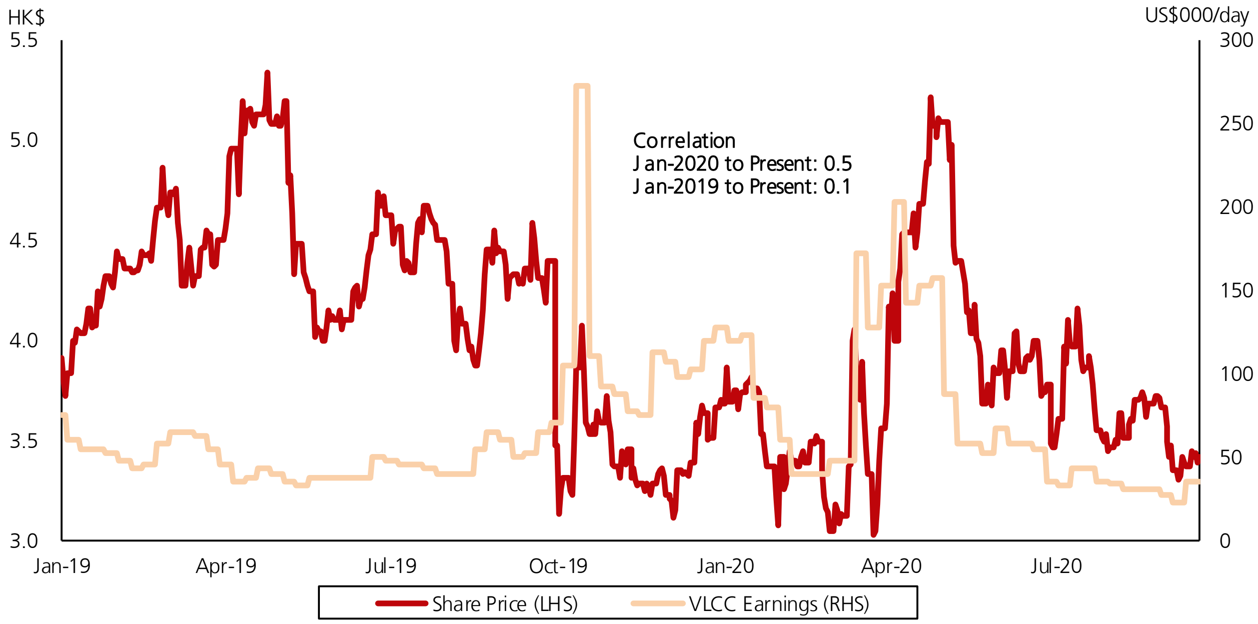
Historical and projected DPS and payout ratio



Source: Company, DBS HK

Rebound in freight rates could drive a re-rating. CSET's share price has been mirroring changes in freight rates over the past year. While freight rates appear to be bottoming out after tumbling 50% y-o-y in August, we believe they could remain soft in the near-term given the weaker than expected recovery in demand. However, we expect freight rates to march higher from current levels, as sector supply-demand rebalances, and this should consequently catalyse a re-rating for CSET.

Correlation between CSET's share price and VLCC freight rates



Source: Clarksons, Bloomberg Finance L.P., DBS HK

Peer Comparison

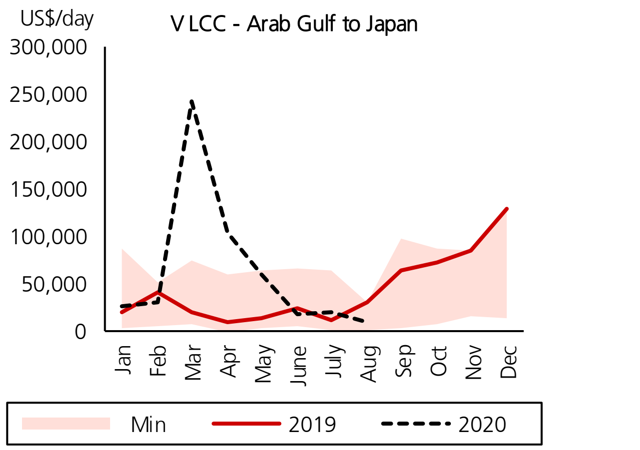
Company	Market cap (US$m)	P/E (X) CY20F	P/E (X) CY21F	EV-to-EBITDA (X) CY20F	EV-to-EBITDA (X) CY21F	P/B (X) CY20F	P/B (X) CY21F	ROE (%) CY20F	ROE (%) CY21F
Oil and refined oil tankers									
Euronav	1,952	3.3	12.3	3.3	5.7	0.8	0.8	26.3	8.3
Tsakos Energy	149	2.5	3.9	6.0	9.6	NA	NA	NA	NA
Frontline Ltd	1,285	2.5	6.0	4.4	7.2	0.8	0.8	31.5	15.1
Nordic American Tankers	522	5.6	8.0	4.4	4.7	NA	NA	12.7	13.2
DHT Holdings	881	2.7	7.4	2.8	4.3	0.8	0.7	18.6	5.6
Scorpio Tankers	649	3.1	4.1	5.6	5.5	0.3	0.3	4.9	0.1
China Merchants	5,717	7.2	9.2	6.4	6.5	1.3	1.2	16.0	12.4
Diamond S Shipping	278	2.6	2.7	3.4	2.8	0.2	0.2	3.7	1.2
International Seaways Inc	409	2.8	3.6	3.3	3.2	0.4	0.3	6.7	4.9
Hafnia Ltd	570	2.7	3.9	4.2	4.5	0.5	0.4	12.7	9.1
Ardmore Shipping Corp	118	8.1	8.9	6.5	6.1	0.3	0.3	2.0	3.0
Teekay Tankers Ltd	365	1.7	5.1	2.1	2.3	0.3	0.3	10.0	0.1
Torm PLC	508	3.1	10.0	3.2	4.8	0.5	0.4	11.6	3.4
Mitsui OSK Lines	2,354	32.2	8.0	17.4	12.7	0.5	0.5	1.6	5.9
	Median	3.0	6.7	4.3	5.15	0.5	0.4	11.6	5.6
Cosco Shipping Energy	**4,144**	**3.9**	**5.3**	**6.1**	**7.2**	**0.4**	**0.3**	**11.2**	**8.9**

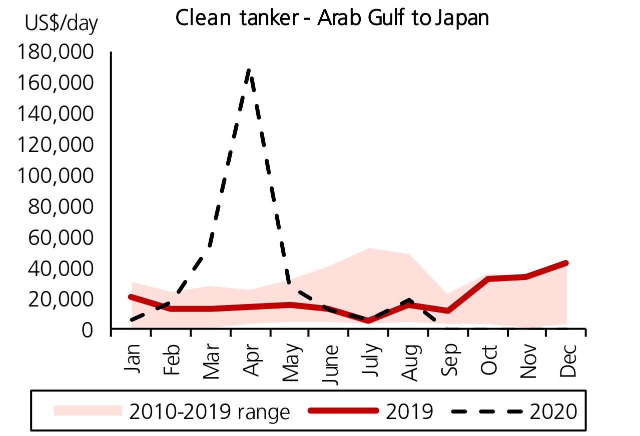
Source: Bloomberg Finance L.P., DBS HK

Sector Outlook

1H20 saw freight rates skyrocketing to the stratosphere… Crude oil and oil product tanker freight rates rose to astronomical levels in 1H20 (+75% y-o-y for the six month period), as traders and oil companies booked out available tankers to capitalise on the steep contango structure (due to the supply glut caused by a rapid plunge in demand) in the crude oil/oil products market during the period.

Hard landing in freight rates after a frenzy in 1Q2020

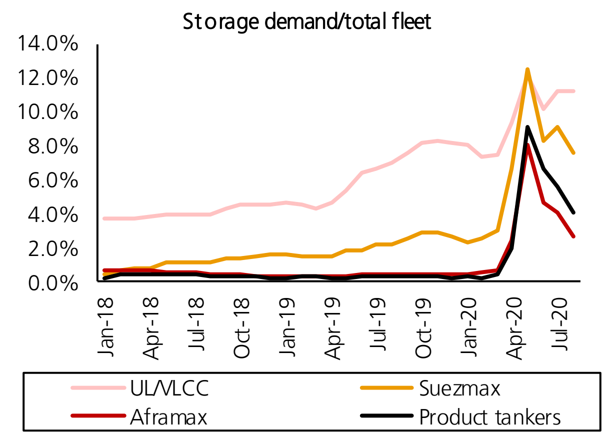




Source: Bloomberg Finance L.P., DBS HK

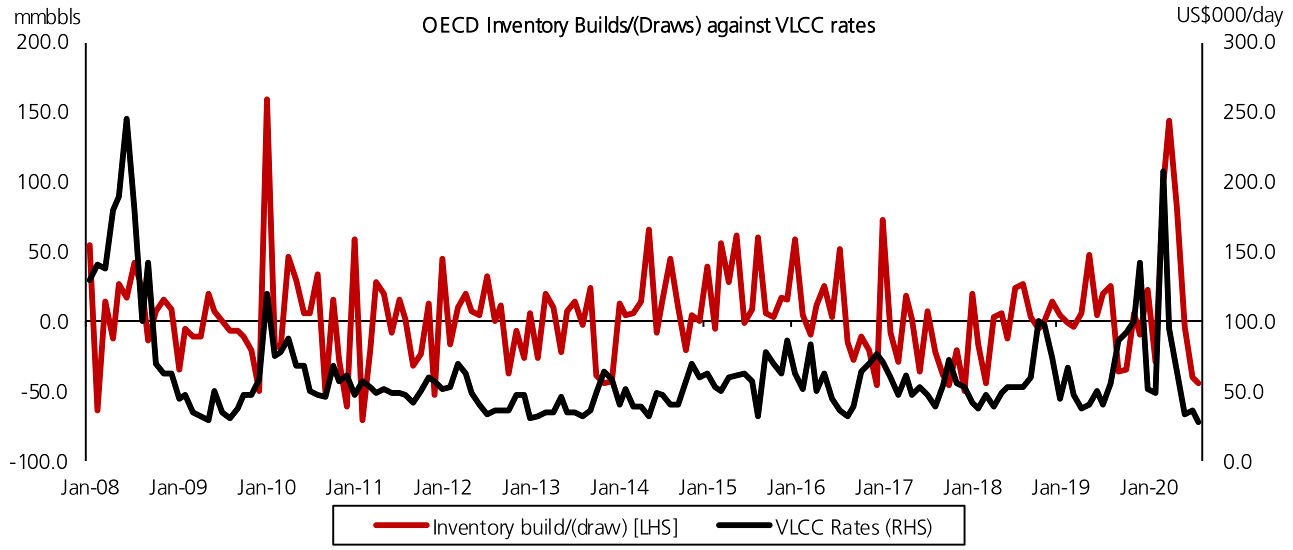
…but the picture is less rosy in the short term as inventory destocking will overshadow a gradual recovery in transportation demand. Based on data from Clarksons, storage demand accounted for 11.2% and 7.5% of total VLCC and Suezmax fleet capacity as at August 2020, down from the peak of 12.2% and 12.5% in May 2020 respectively. As crude oil demand gradually normalises on the back of a turnaround in the global economy and easing of lockdowns, continued inventory draws leading to a return of storage tankers into the spot market will weigh heavily on freight rates. The scenario appears slightly more favourable for the oil products segment, as floating storage as a % of total fleet has already dwindled to c.4.1% in August 2020, from the peak of 9.1% in May 2020.

Storage demand is still at elevated levels



Source: Clarksons, DBS HK

Inventory draws will typically exert downward pressure on freight rates

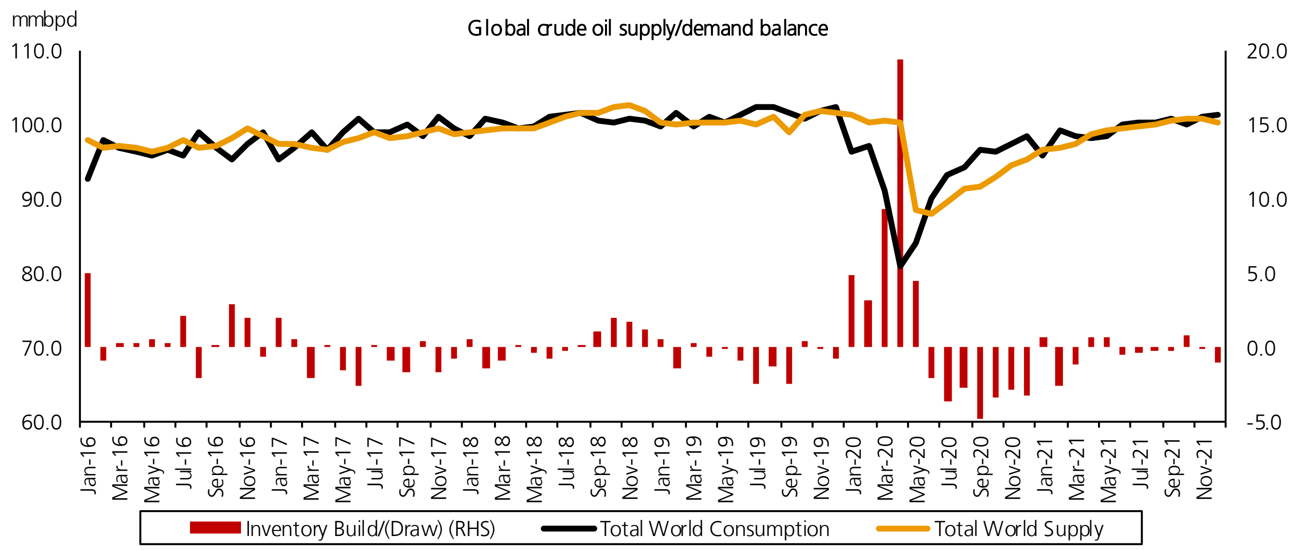


Source: EIA, Clarksons, DBS HK

Supply-demand set up for oil tanker companies could turn positive from FY21F. Following weaker earnings projected in FY21F, we expect robust earnings growth from FY22F as we move through the business cycle, driven by the following:

Transportation demand should have bottomed in 1H20 and progressively improve as upstream companies ease production cuts. Supply should continue trending higher over the next two years, providing a tailwind for oil tanker companies – the OPEC+ alliance is now meeting on a monthly basis, and will likely ramp up production in a timely fashion to match demand recovery. Though we foresee extended unwinding of crude oil inventories into FY21F on the back of demand outpacing supply growth, the impact should be more than offset by the rebound in oil trade growth towards the end of FY21F into FY22F.

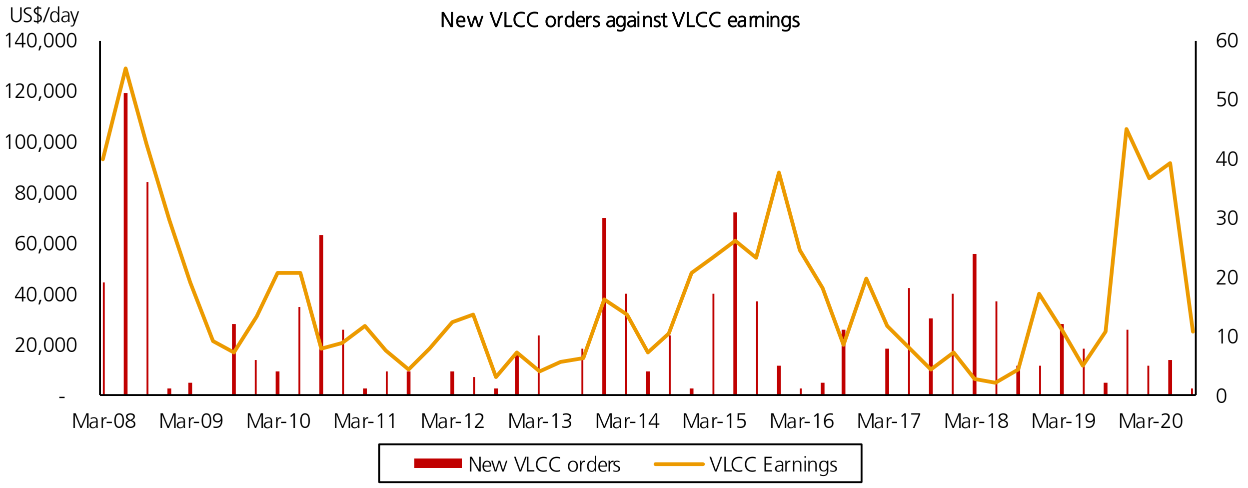
Crude oil supply and demand anticipated to approach pre-COVID19 levels at end-2021



Source: EIA, DBS HK

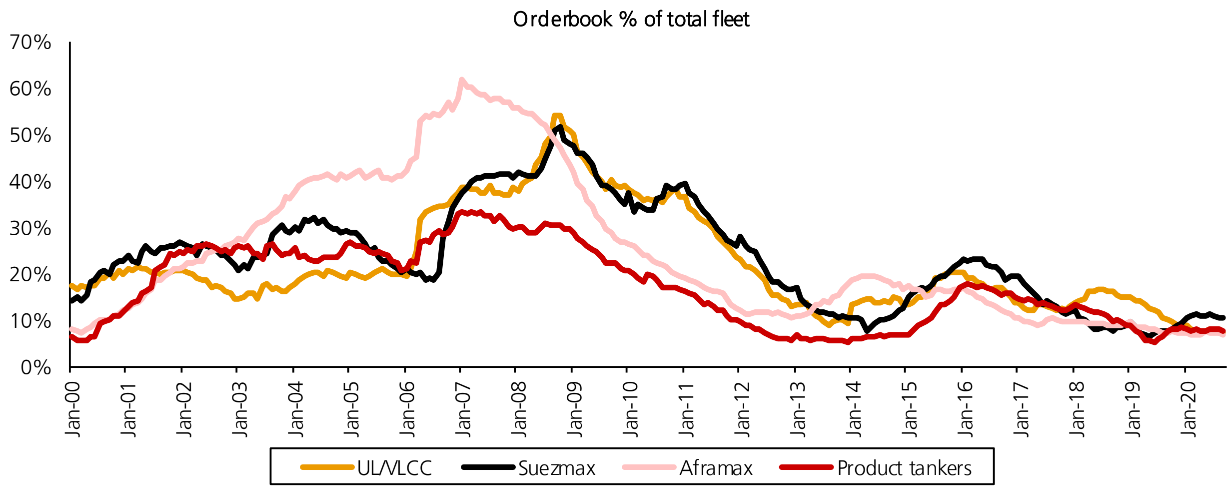
Tanker supply to tighten, underpinned by limited new builds, and increasing proportion of ageing tankers. As at September 2020, VLCC, Suezmax and oil product tanker orderbook as a percentage of total fleet stood at historical low levels of 7.1%, 10.5% and 7.0% respectively. Surprisingly, despite robust VLCC earnings over the past three quarters, new tanker orders (which historically has demonstrated a strong correlation with VLCC rates) continued to be sluggish.

New VLCC orders did not gain momentum despite strong freight rates in 1Q-2Q2020



Source: Clarksons, DBS HK

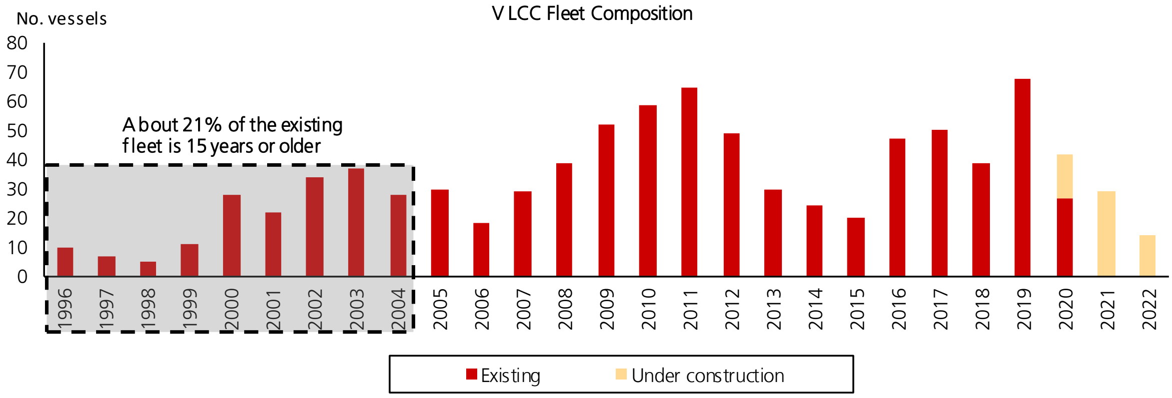
Orderbook-to-fleet ratio has been on a downtrend over the past five years

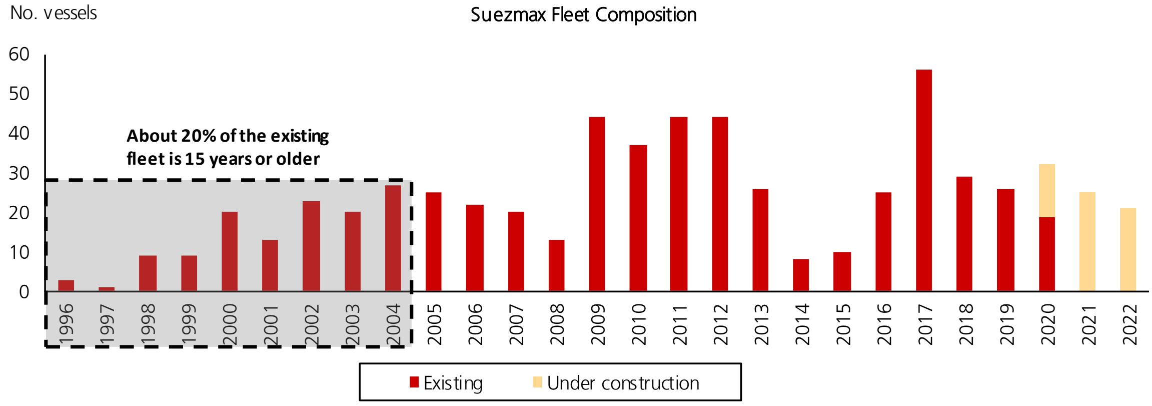


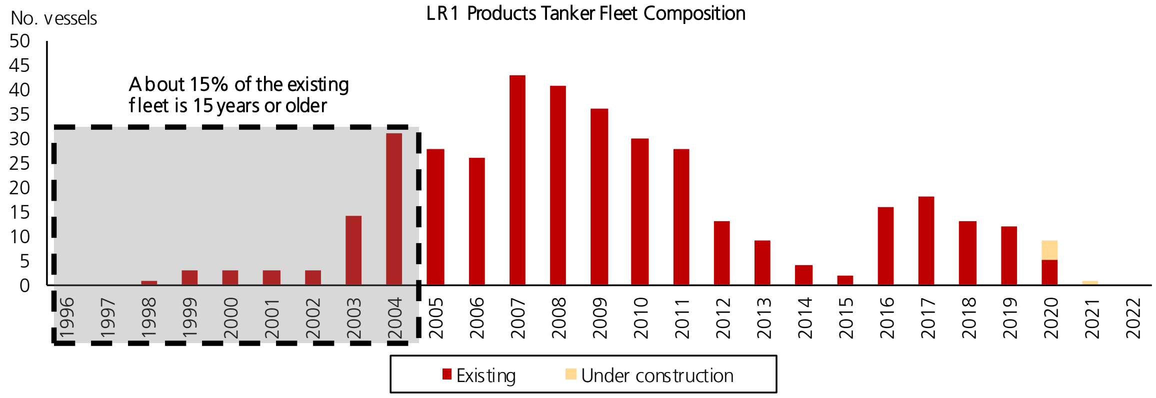
Source: Clarksons, DBS HK

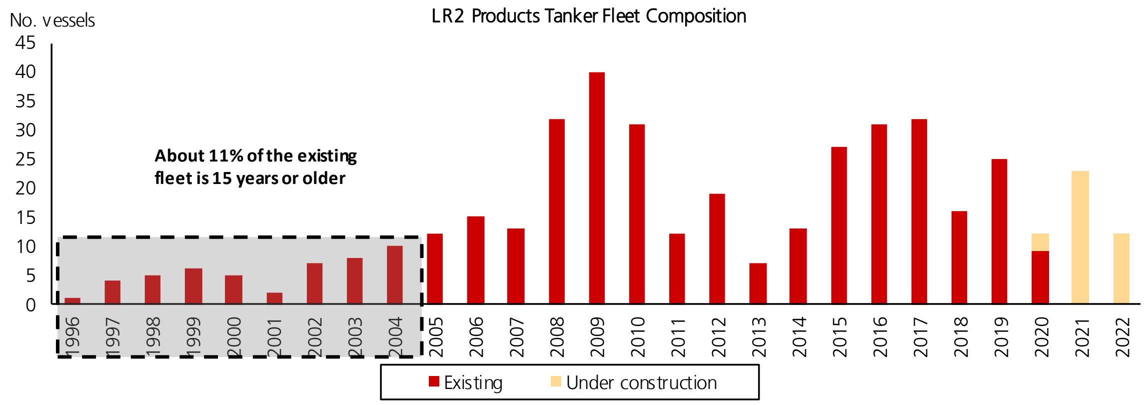
Additionally, the global fleet composition is becoming more constructive for companies like CSET with a modern fleet – as at September 2020, 21%,20%,11% and 15% of the VLCC, Suezmax, LR2 and LR1 product tanker fleet respectively were above 15 years old and will now have to undergo two special periodic surveys (SPS) in the next five years (up from one SPS every five years). Such surveys cost in excess of US$3-4m, depending on the condition and the useful life of the vessel. Finding employment for vintage vessels in an oversupplied market is a challenging task, and if market conditions do not improve and freight rates stay persistently muted at below breakeven levels, this could catalyse vessel scrappage, creating a tighter market for incumbents like CSET.

Vessel supply may be tighter than it seems



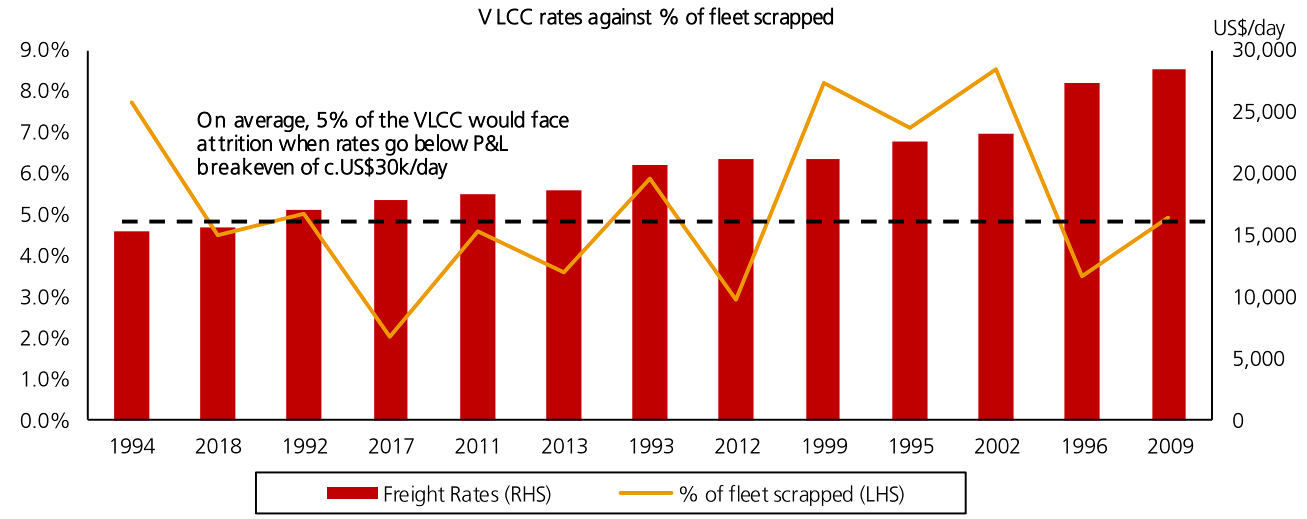






Source: Clarksons, DBS HK

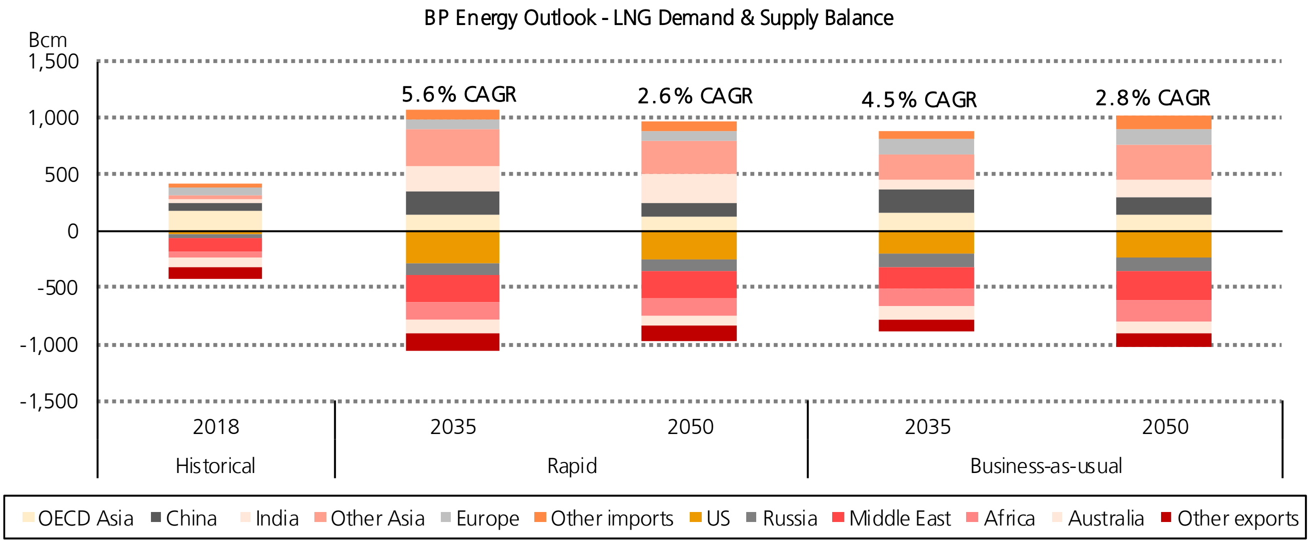
Depressed freight rates will likely catalyse attrition and expedite rebalancing of supply and demand



Source: Clarksons, DBS HK

Increased exposure to LNG carrier market will be positive in the medium-long term. CSET has plans to broaden its exposure to the liquified natural gas carrier (LNGC) segment, via building up its own LNGC fleet and through JVs/associates with strategic partners. Though spot freight rates for LNGCs is expected to remain soft due to oversupply in the short term, we believe that the segment has bright long-term growth prospects. CSET's position as a leading player in China is advantageous as China is projected to overtake Japan to be the world's largest LNG importer in a few years' time.

COVID-19 will likely accelerate the green transition, and drive the use of natural gas/LNG as a bridging fuel



Source: Clarksons, DBS HK

Higher quantum of energy commodity imports from the US could boost nautical miles per voyage. Though this element will not be prominent in the near-term, given the collapse in US energy exports, we believe that a steady revival in the US energy sector is beneficial for oil tanker/LNGC companies. The US is situated further than most other countries exporting energy commodities to central demand points in Asia and other parts of the world. Hence, greater energy exports from the US would lead to vessels travelling considerably longer distances and translate into better vessel utilisation.

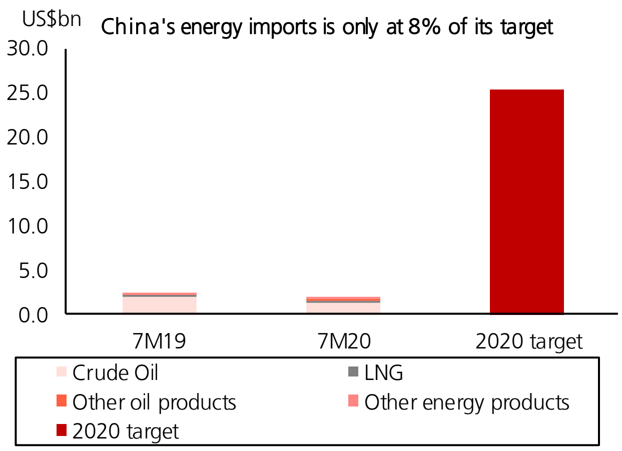
Phase I of trade deal between China and US will benefit CSET. As part of phase I of the trade deal between China and the US, China is required to import US$25.3bn of energy products in 2020 from the US. China only achieved 5% of the target in 1H2020, and we believe that despite rising geopolitical tensions between the two countries, China will accelerate crude oil and LNG imports to show some goodwill. If so, this would benefit CSET, as the company has a strong market presence in China's crude oil imports.

Average voyage length (one-way, in nautical miles)

To/From	US	Australia
China	10,081	3,322
Japan	9,209	3,727
United Kingdom	4,897	-

Source: Clarksons, DBS HK

China will need to accelerate energy imports from the US to meet its pledge



Source: Bloomberg Finance L.P., DBS HK

Key Risks

High spot market exposure. The crude oil & oil product tanker markets are highly cyclical, with freight rates typically driven by the interplay between supply and demand (both storage and transportation), that can shift abruptly for numerous reasons. This year alone saw freight rates skyrocket 290-300% between Jan-Mar 2020, only to plummet 84% between Mar-June 2020. CSET has about 80% of its VLCC fleet (c.40% of revenue) on spot charters and will take a directly hit from changes in spot freight rates. Vessels in its other segments temper this risk, as they are predominantly on long-term charters with more stable operating margins.

OPEC+ crude oil production cuts extending beyond expectations. The OPEC+ alliance, led by Saudi Arabia and Russia, first implemented a production cut of 9.7mmbpd in May to cope with the unprecedented fall in global crude oil demand. The alliance is now steadily unwinding production cuts, as demand advances to pre-COVID19 levels, which is positive for global crude oil trade. However, a resurgence in COVID-19 cases, or the situation prolonging due to lack of a viable vaccine could see global crude oil demand dive again, which could elicit another supply response from the OPEC+ committee.

Peak crude oil demand. A growing chorus of concern highlights the possibility that 2019 may have been the peak of crude oil demand, as COVID-19 has drastically altered the energy landscape, driving changes in consumer behaviour and implementation of more green policies. While we are not proponents of this theory and instead believe that peak crude oil demand will only materialise towards to the end of the decade, it is certainly possible that COVID-19 could accelerate the timeline. Consequently, this will result in lesser demand for crude oil transportation, with adverse implications on oil tanker companies like CSET.

Unfavourable fuel price fluctuations. Fuel cost typically represents the largest portion of operating costs (20-30% of total operating costs) and tends to be volatile as it largely tracks changes in crude oil prices. CSET does not have scrubbers installed on any of their vessels and plans to use Very Low Sulfur Fuel (VLSFO) to comply with IMO2020 regulations.

SWOT Analysis

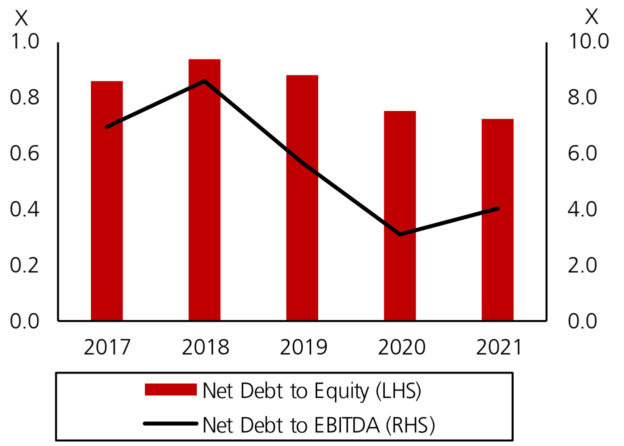
Strengths	Weaknesses
• Integrated asset portfolio; one of the largest, most modern and diverse fleet (average age of around 7 years) of crude oil and oil product tankers, and LNG carriers. • Dominant market position with c.55% share in coastal crude oil transportation in China; largest crude oil importer in the world. • Growing fleet of LNG carriers is also a key positive, given that China is expected to become the largest LNG importer over the next few years. • Domestic operations and LNG segment are fairly resilient, providing a buffer for its volatile international business. • As part of the Cosco Shipping Group, CSET is able to enjoy preferential rates on port fees and other costs.	• Limited earnings visibility, due to the company's high exposure to the spot market. • Capital intensive business, which necessitates elevated levels of investments in vessels.
Opportunities	**Threats**
• Marketable supply of crude oil tankers is expected to shrink over the next few years. • Crude oil and oil product transportation demand should have bottomed in 1H20 and will trend towards pre-crisis levels over the next few years. • Increase in trading of energy commodities between the US and China would boost nautical mile per voyage and translate into higher vessel utilisation.	• Peak oil demand will have profound implications on the long-term crude oil and oil products transportation demand. • The crude oil tanker sector is highly cyclical, with volatile freight rates and operating costs. • Protracted or deeper than expected OPEC+ production cuts could dent transportation demand. • Oversupply in LNG carrier market could persist if economic growth continues to be lacklustre.

Source: DBS HK

Financials

Healthy balance sheet with sound credit metrics. CSET's credit metrics as at 1H-2020 like net debt-to-EBITDA and net gearing are in line with the sector average, at 6.0x (industry average: 4.9x) and 0.9x (industry average: 0.9x) respectively. The company generally enjoys a moderately low cost of debt, ranging between 4-5%, and has a well spread out debt maturity profile. As per industry practice, majority of CSET's loans are mortgage loans which are backed by its vessels.

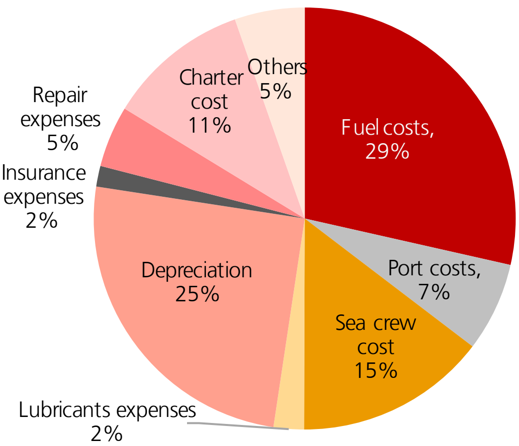
Historical and projected key credit metrics



Source: Company, DBS HK

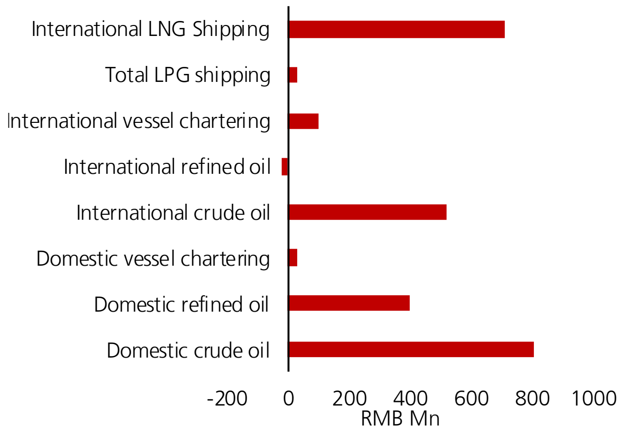
Operating margins have historically been volatile; high proportion of costs are fixed. As elaborated in this report, the crude oil tanker/LNG carrier markets are cyclical in nature, with wild fluctuations in freight rates and fuel prices. Over the past five years, CSET's gross margin peaked at 29.9% in 2015, and hit a trough of 14.8% in 2018. This can largely be attributed to the operating leverage that is inherent in CSET's business – we estimate that around 40-50% of costs are fixed, while fuel accounts for the majority of variable costs, at around 30% of total operating costs as at FY2019.

Operating cost breakdown



Source: Company, DBS HK

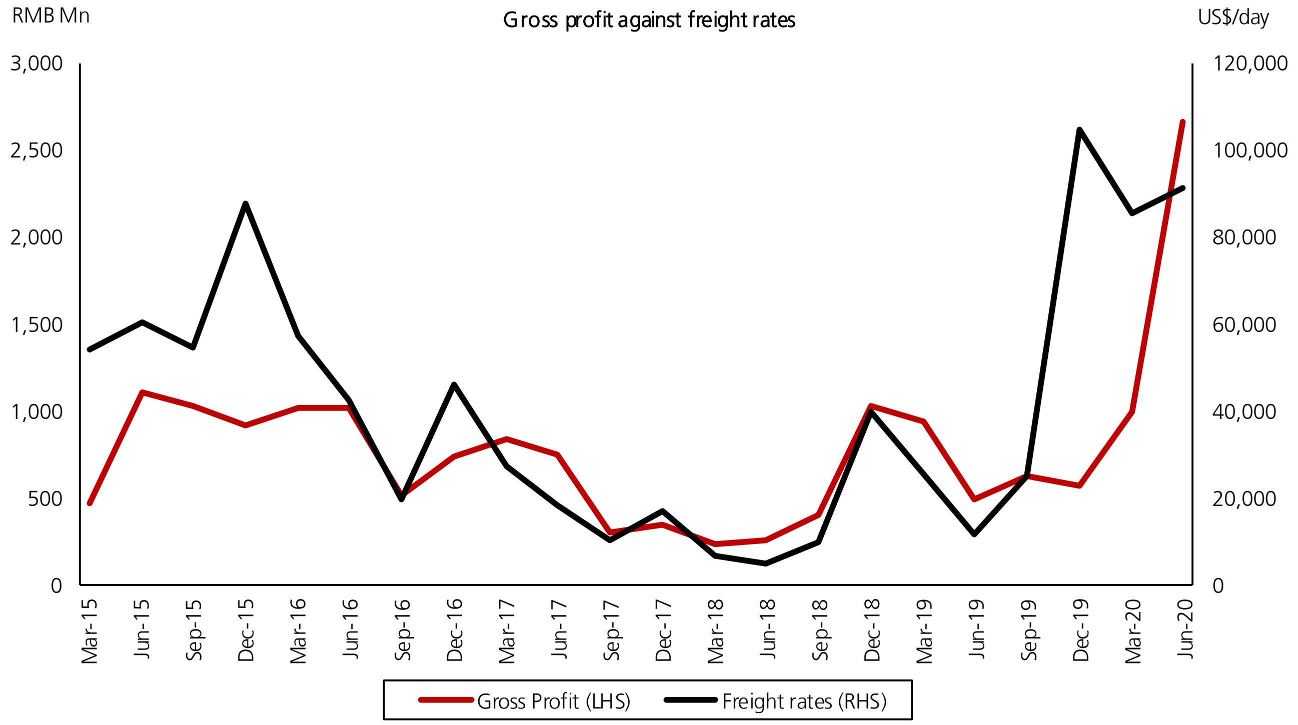
Gross profit by segment (FY19)



Source: Company, DBS HK

Domestic and LNG operations are generally more stable; earnings mirrors changes in freight rates but to a smaller extent than peers. CSET's domestic business are less volatile compared to its international operations, due to its dominant market position and established relationships with its core customers. Furthermore, the company's LNG carrier segment is also able to churn consistent earnings/cash flows, as all its LNG vessels are locked in long-term contracts. Together, these two segments accounted for around 75% of total gross profits in 2019. Thus, while CSET's earnings are invariably influenced by changes in spot rates, we notice that its gross profits have been less volatile compared to freight rates in the past five years.

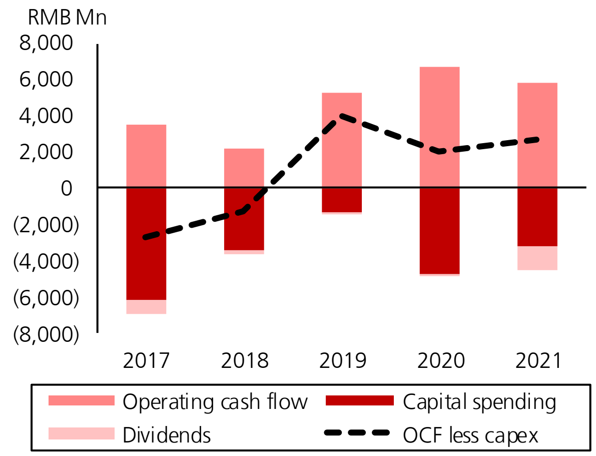
CSET's earnings tracks changes in freight rates to a moderately high degree



Source: Clarksons, Company, DBS HK

Strong financial flexibility; 30-40% dividend payout ratio should be sustainable. We note that CSET generally has strong access to funding, both via banks and debt capital markets. The company has demonstrated strong capital management during various phases in the business cycle – paying off substantial amount of debt at the top of the cycle and purchasing more vessels at depressed prices at the bottom of the cycle. While CSET has no fixed dividend policy, we expect the company to maintain a dividend payout ratio at 30-40%, as the company still has plans to expand its fleet, especially LNG vessels.

Historical and projected free cash flows



Source: Company, DBS HK

Company Background

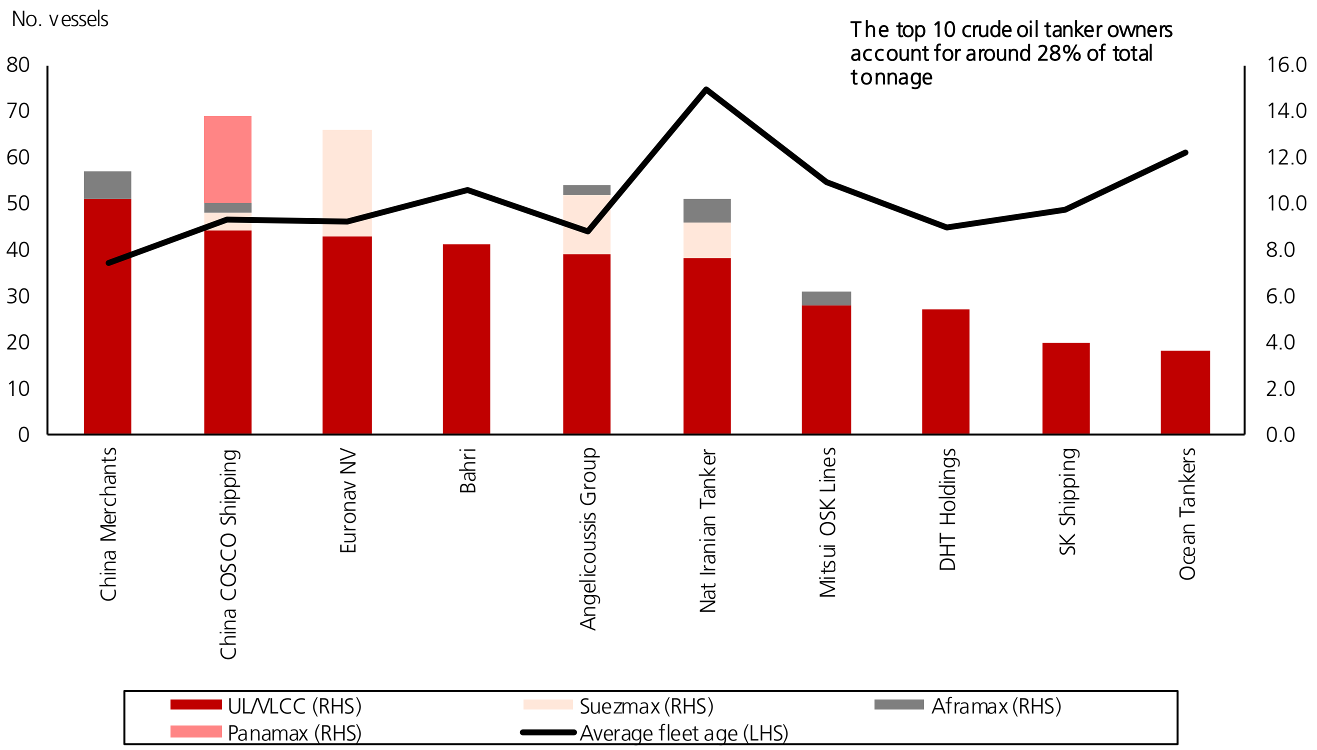
Corporate History. CSET is one of the world's largest crude oil/oil product tanker companies, owning and operating 151 oil tankers with a total capacity of 21.7m dead weight tonnage (DWT) as at Dec-2019. CSET has a dominant presence in the domestic market, with a market share of over 55% in the coastal crude oil transportation market. Furthermore, CSET is also involved in the transportation of LNG via its wholly-owned subsidiary – Cosco Shipping LNG Shanghai (Shanghai LNG) - and China LNG Shipping (CLNG). As at Dec-2019, the group owned a total of 35 LNG carriers, with an aggregate capacity of 5.9mcm.

Industry Background. Crude oil tankers are primarily used in the seaborne transportation of crude oil produced by upstream companies to end users (largely refineries), although they are sometimes used for storage purposes. Similarly, LNG carriers are used to transport LNG from liquefaction terminals to regasification terminals but are less commonly used for storage purposes as storing LNG causes some of the LNG to boil-off.

The sector is highly fragmented on the supply side of the equation, with many small ship owners – the ten largest crude oil and oil product tanker companies command a mere 28% and 21% of global market share. On the contrary, the LNG carrier market is considerably more concentrated, with the ten largest companies holding 51% share of the global market.

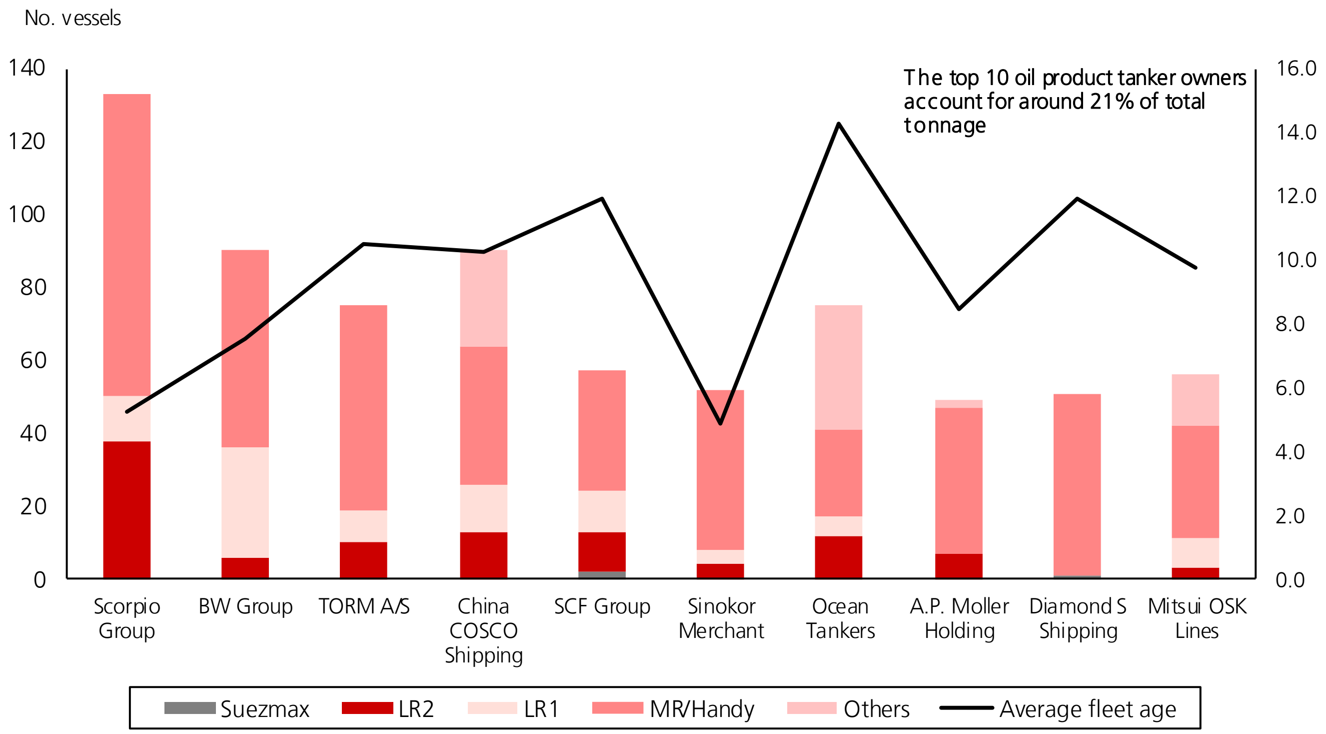
LNG vessels generally exhibit more stable earnings; oil tankers more exposed to spot freight rates. Majority of LNG carriers in the market are on long-term charters, as they are often bound to specific LNG projects. Whereas crude oil/oil product tankers tend to have a fair mix of spot and long-term contracts, though the duration of long-term contracts tend to be much shorter compared to LNG vessels.

Global crude oil tanker fleet structure



Source: Clarksons, DBS HK

Global oil product tanker fleet structure



Source: Clarksons, DBS HK

Management & Strategy

Competent and seasoned management team. CSET's management team comprises highly regarded professionals and veterans in the energy commodity transportation sector. Most of the members in the senior management team have over twenty years of relevant experience and held or currently are holding important positions in other companies under the Cosco Group.

Core strategy revolves around enhancing integrated services offering, and pivot towards transportation of cleaner energy sources. CSET plans to grow its crude oil/oil product tanker fleet to capitalise on new refinery capacity additions in China over the next five years. In doing so, CSET will be able to service both customers' import and export requirements. Additionally, CSET has set goals to accelerate the development of its LNG fleet, in order to meet China's burgeoning LNG demand.

Key Management Team

Name	Position	Background and Experience
Liu Hanbo	Executive Director Chairman of both the Strategy and Risk Control Committee of the company Director of Cosco Shipping Captive Insurance Co. Ltd	- Joined the company in August 2016 - Has more than 30 years of industry experience - Previously held management positions in other companies under the Cosco Group
Zhu Maijin	Executive Director General manager of CSET Member of the Strategy Committee	- Joined the company in 1996 - Has more than 30 years of industry experience - Previously held other management positions in other companies under the Cosco Group
Xiang Yongmin	Chief Financial Officer	- Joined the company in June 2016 - More than 30 years of experience in the financial sector - Former Deputy General Manager of the company from June 2016 to August 2017

Source: Company

Critical Factors to Watch

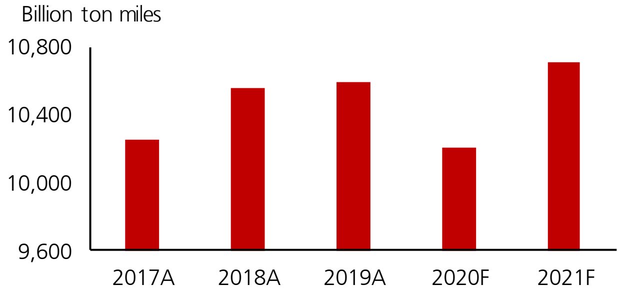
Demand for energy commodities. The demand for crude oil and LNG is an obvious demand driver for crude oil tankers and LNG carriers, given that demand centres such as refineries and regasification terminals are rarely located close to the sources. Under normal circumstances, we believe that crude oil prices hovering within the range of US$40-60 per barrel and Japan Korea Market at US$3-4 per mmbtu tend to be demand stimulating. Demand for crude oil/oil products and LNG should have bottomed in 1H20, and we expect a steady, albeit measured recovery going forward, assuming the COVID-19 situation does not extend beyond our expectations.

Supply of energy commodities. The supply of crude oil and natural gas is crucial to the status and balance of its respective markets. Supply in excess of demand generally leads to inventory builds – in the oil market, this would drive demand for VLCC used for storage purposes. Conversely, destocking results in more tankers in the market available for transportation, which will have a negative impact on freight rates. Crude oil supply should continue trending upwards, as the OPEC+ alliance unwinds its production cuts, while we expect strong momentum in LNG supply on the back of new capacity additions, largely in the US.

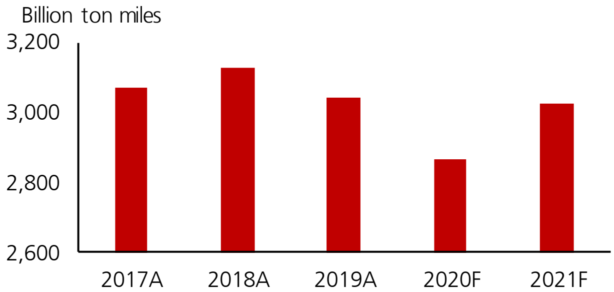
Forward curve of energy commodity prices. VLCC freight rates have historically moved in tandem with changes in the forward curve of crude oil prices. A deep contango structure is the most advantageous to crude oil tanker companies, as it increases the incentive for storage, reducing vessels available for transportation, and consequently driving an increase in freight rates. Looking ahead, we believe the current contango in the crude oil market will gradually shift to backwardation on the back of increased demand for prompt deliveries. This will likely result in day rates remaining under pressure in the short-term.

Changes in vessel supply. Another key driver of the oil tanker/LNG carrier markets is vessel supply. Supply is largely a function of the number of newbuilds delivered, against the number of vessels demolished/scrapped. A more relevant supply metric is effective supply – desirable vessels that are actively seeking employment. Factors that could impact effective supply include sanctions on certain shipping companies, or an increase in vessels over fifteen years of age, as most charterers will not use such vintage vessels for cargo delivery. At this juncture, while the orderbook to fleet ratio for LNG carriers remains elevated, the ratio for the VLCC/Suezmax segments is now at the lowest point in the past 20 years, suggesting that new supply will come online slowly.

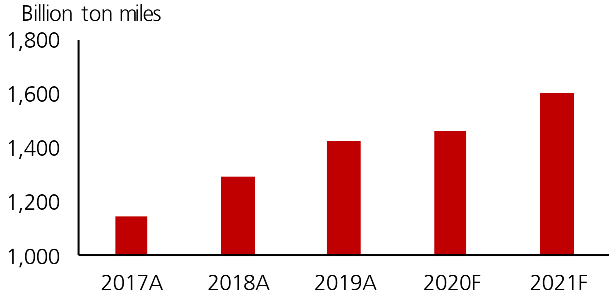
Seaborne Crude Oil Trade



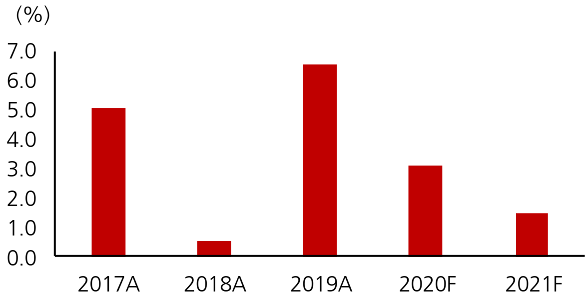
Seaborne Oil Products Trade



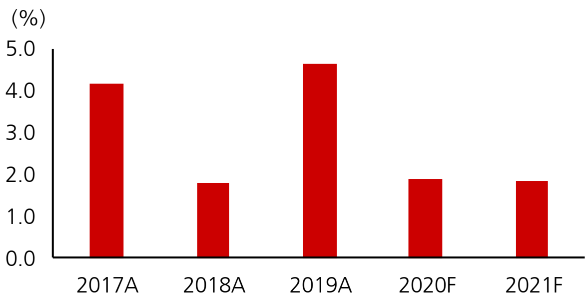
World Seaborne LNG Trade



Crude Tanker Fleet Growth (y-o-y)



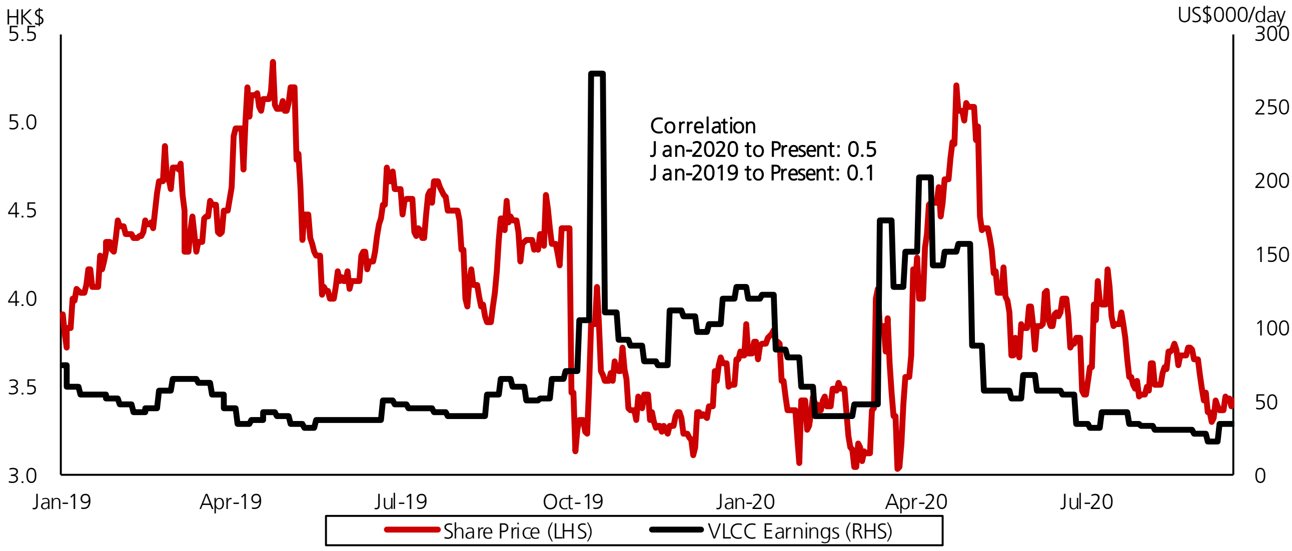
Oil Product Fleet Growth (y-o-y)



Source: Company, Clarkson, DBS HK

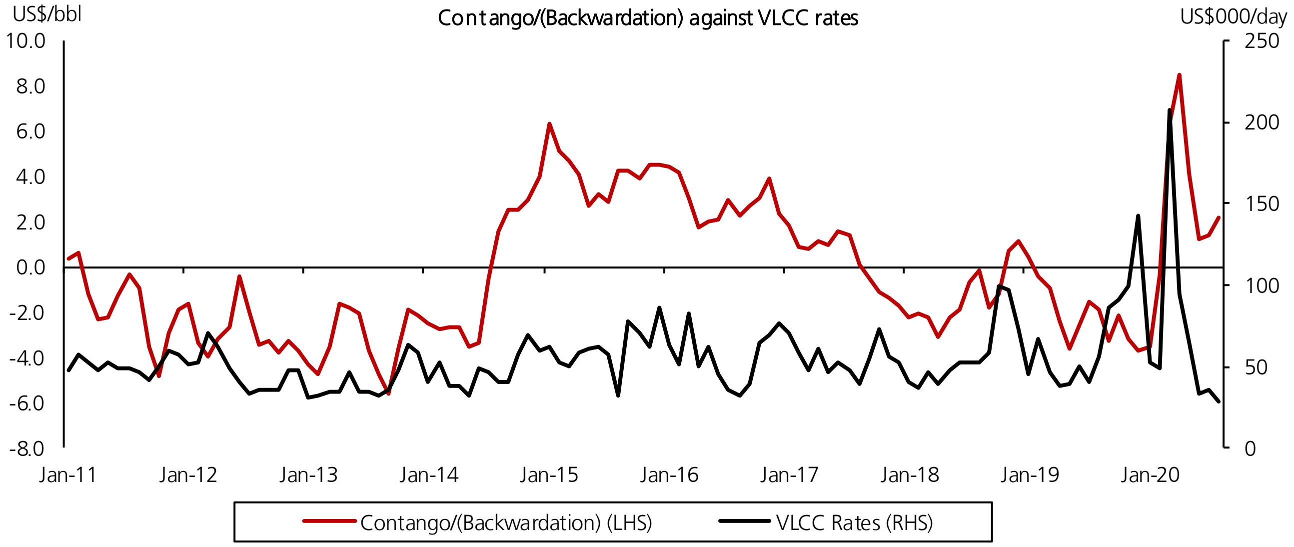
Appendix 1: A look at Company's listed history – what drives its share price?

CSET's share price has been tracking prevailing freight rates closely in 2020



Source: Clarksons, Bloomberg Finance L.P., DBS HK

Freight rates typically mirror changes in the degree of contango in crude oil prices



Source: Clarksons, Bloomberg Finance L.P., DBS HK

Balance Sheet:

Financial leverage in line with peers. We believe CSET's balance sheet is sound, and on-par with its peers. As at June-2020, the company's net debt to EBITDA and net gearing ratio stood at 3.3x and 0.8x respectively. While CSET has ambitious capacity expansion goals, we believe the company's robust operating cash flows and strong access to external funding will enable it to finance its capital investments with ease.

Share Price Drivers:

Changes in crude oil/LNG demand and supply. Increased demand and supply of crude oil and LNG directly drives transportation demand. Inventory builds would also reduce available capacity of vessels to transport energy commodities, and lead to a tighter market. Both factors would lead to an increase in freight rates, and correspondingly, operating profits.

Changes in global vessel supply. An increase in vessel supply typically occurs if vessel deliveries outpace vessel demolition/scrappage in a year. Effective supply can be affected by other factors, such as sanctions on shipping companies, or the vessel's age and specifications – charterers often prefer modern vessels over vintage vessels, while shipowners may not elect to keep older vessels seaworthy due to the higher costs and increased frequency of special periodic surveys that these ships have to undertake.

Key Risks:

Key risks include: 1) duration of COVID-19 extending beyond our expectations, leading to sustained production cuts by upstream producers globally, 2) elevated exposure to the spot market will be negative for earnings if freight rates continue to be soft.

Environmental, Social, Governance:

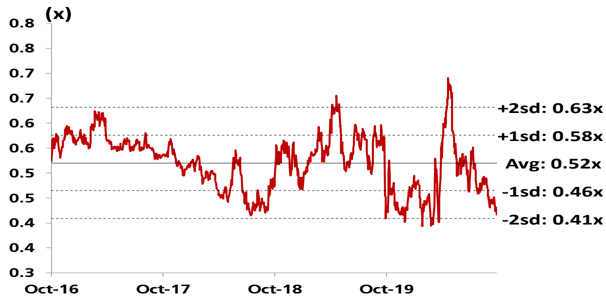
Leader in ESG; adapting business model to support greener energy sources. CSET fares better than most peers with regards to ESG disclosure and has clinched many ESG awards over the past few years. While the transportation of crude oil and oil products will remain its core business for the foreseeable future, CSET is actively taking steps to develop transportation capabilities for new energy sources like LNG and ethane to support China's pivot to sustainable energy.

Company Background

CSET is one of the world's largest crude oil/oil product tanker companies, owning and operating 151 oil tankers with a total capacity of 21.7m dead weight tonnage (DWT) as at Dec-2019. CSET has a dominant presence in the domestic market, with a market share of over 55% in the coastal crude oil transportation market. Furthermore, CSET is also involved in the transportation of LNG, via its wholly-owned subsidiary – Cosco Shipping LNG Shanghai (Shanghai LNG) - and China LNG Shipping (CLNG). As at Dec-2019, CSET owned a total of 35 LNG carriers, with an aggregate capacity of 5.9mcm.

Forward PE Band

PB Band



Source: Company, DBS HK

Income Statement (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Revenue	9,505	12,100	13,721	17,500	15,848
Cost of Goods Sold	(7,251)	(10,304)	(11,125)	(11,174)	(11,642)
Gross Profit	**2,254**	**1,796**	**2,596**	**6,326**	**4,207**
Other Opng (Exp)/Inc	(663)	(771)	(926)	(1,085)	(998)
Operating Profit	**1,591**	**1,025**	**1,670**	**5,241**	**3,208**
Other Non Opg (Exp)/Inc	672	81	(64)	(30)	1
Associates & JV Inc	418	508	715	655	717
Net Interest (Exp)/Inc	(626)	(1,179)	(1,316)	(1,091)	(1,069)
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	(22)	(3)	(25)	0
Pre-tax Profit	**2,055**	**413**	**1,002**	**4,750**	**2,856**
Tax	(162)	(120)	(330)	(712)	(571)
Minority Interest	(119)	(219)	(258)	(250)	(250)
Preference Dividend	0	0	0	0	0
Net Profit	**1,775**	**75**	**414**	**3,787**	**2,035**
Net Profit before Except.	1,775	97	417	3,812	2,035
EBITDA	4,589	3,795	5,195	8,717	6,835
Growth					
Revenue Gth (%)	(3.1)	27.3	13.4	27.5	(9.4)
EBITDA Gth (%)	0.4	(17.3)	36.9	67.8	(21.6)
Opg Profit Gth (%)	(21.5)	(35.6)	63.0	213.9	(38.8)
Net Profit Gth (%)	51.4	(95.8)	454.2	815.2	(46.3)
Margins & Ratio					
Gross Margins (%)	23.7	14.8	18.9	36.2	26.5
Opg Profit Margin (%)	16.7	8.5	12.2	30.0	20.2
Net Profit Margin (%)	18.7	0.6	3.0	21.6	12.8
ROAE (%)	6.4	0.3	1.5	12.7	6.3
ROA (%)	3.0	0.1	0.6	5.6	2.9
ROCE (%)	2.0	(1.8)	(1.5)	4.3	1.5
Div Payout Ratio (%)	43.2	270.0	19.5	5.0	65.1
Net Interest Cover (x)	2.5	0.9	1.3	4.8	3.0

Source: Company, DBS HK

Balance Sheet (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Net Fixed Assets	44,891	49,331	51,576	53,425	53,715
Invts in Associates & JVs	4,434	5,208	5,542	6,197	6,913
Other LT Assets	3,810	1,933	1,797	1,797	1,797
Cash & ST Invts	5,011	3,468	3,920	3,562	3,228
Inventory	656	927	774	1,552	1,318
Debtors	954	752	938	1,364	1,241
Other Current Assets	631	1,798	1,296	1,810	1,358
Total Assets	**60,389**	**63,416**	**65,842**	**69,706**	**69,571**
ST Debt	6,952	8,602	8,598	8,307	8,161
Creditors	1,047	1,454	1,922	2,670	2,242
Other Current Liab	876	825	1,828	2,098	1,930
LT Debt	22,327	22,387	20,908	20,200	19,845
Other LT Liabilities	921	875	3,418	3,418	3,418
Shareholder's Equity	27,923	28,192	28,125	31,722	32,431
Minority Interests	342	1,081	1,043	1,293	1,543
Total Cap. & Liab.	**60,389**	**63,416**	**65,842**	**69,706**	**69,571**
Non-Cash Wkg. Capital	319	1,198	(742)	(41)	(255)
Net Cash/(Debt)	(24,268)	(27,522)	(25,587)	(24,945)	(24,779)
Debtors Turn (avg days)	41.7	25.7	22.5	24.0	30.0
Creditors Turn (avg days)	82.0	56.2	74.7	100.7	102.7
Inventory Turn (avg days)	38.0	35.6	37.6	51.0	60.0
Asset Turnover (x)	0.2	0.2	0.2	0.3	0.2
Current Ratio (x)	0.8	0.6	0.6	0.6	0.6
Quick Ratio (x)	0.7	0.4	0.4	0.4	0.4
Net Debt/Equity (X)	0.9	0.9	0.9	0.8	0.7
Net Debt/Equity ex MI (X)	0.9	1.0	0.9	0.8	0.8
Capex to Debt (%)	21.0	11.1	4.3	16.5	11.4
Z-Score (X)	NA	NA	NA	NA	NA

Source: Company, DBS HK

Cash Flow Statement (RMB m)

FY Dec	2017A	2018A	2019A	2020F	2021F
Pre-Tax Profit	2,055	413	1,002	4,750	2,856
Dep. & Amort.	1,908	2,181	2,874	2,851	2,910
Tax Paid	(253)	(92)	(115)	(712)	(571)
Assoc. & JV Inc/(loss)	(418)	(508)	(715)	(655)	(717)
(Pft)/ Loss on disposal of FAs	0	0	0	0	0
Chg in Wkg.Cap.	(579)	(1,031)	852	(700)	214
Other Operating CF	736	1,193	1,333	1,189	1,159
Net Operating CF	**3,449**	**2,156**	**5,230**	**6,722**	**5,850**
Capital Exp.(net)	(6,156)	(3,445)	(1,276)	(4,700)	(3,200)
Other Invts. (net)	0	15	0	0	0
Invts in Assoc. & JV	(150)	0	0	0	0
Div from Assoc & JV	227	220	461	0	0
Other Investing CF	(1,017)	862	139	0	0
Net Investing CF	**(7,097)**	**(2,348)**	**(675)**	**(4,700)**	**(3,200)**
Div Paid	(766)	(202)	(81)	(191)	(1,326)
Chg in Gross Debt	3,845	524	(1,893)	(1,000)	(500)
Capital Issues	0	0	0	0	0
Other Financing CF	(727)	(1,731)	(2,195)	(1,189)	(1,159)
Net Financing CF	**2,351**	**(1,408)**	**(4,169)**	**(2,380)**	**(2,984)**
Currency Adjustments	(77)	57	65	0	0
Chg in Cash	(1,374)	(1,543)	452	(358)	(334)
Opg CFPS (RMB)	1.00	0.79	1.09	1.56	1.18
Free CFPS (RMB)	(0.67)	(0.32)	0.98	0.42	0.56

Source: Company, DBS HK

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

Completed Date: 5 Oct 2020 13:05:45 (HKT)
Dissemination Date: 5 Oct 2020 13:52:36 (HKT)

Sources for all charts and tables are DBS HK unless otherwise specified.

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