Industrials
Asia Shipbuilding

HSBC Global Research

Asia Shipbuilding

Time to stock pick; prefer SHI

Ratings and valuations

	HHI	SHI	DSME	Mipo	Rongsheng
Code	009540 KS	010140 KS	042660 KS	010620 KS	1101 HK
Share price	KRW	KRW	KRW	KRW	HKD
(Local curr)	284,000	29,800	23,800	110,500	2.26
Mkt cap (Local curr)	21,888b	7,203b	4,746b	2,190b	15,400m
Mkt cap (USDm)	18,698	5,960	3,946	1,915	2,037
Rating	N(V)	OW(V)	N(V)	OW(V)	N(V)
TP (new)	KRW 320,000	KRW 38,000	KRW 27,000	KRW 135,000	HKD 2.50
TP (old)	350,000	33,000	30,000	140,000	3.50
Potential return (%)	12.9%	29.1%	15.8%	24.0%	14.9%
2012 PE	7.2	9.3	7.8	8.1	7.5
2012 PB	0.9	1.2	0.9	0.5	0.8

Source: Bloomberg, HSBC estimates.

* Note: Pricing as of 10 January 2012. Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield.

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- **Sector has yet to bottom; shipbuilding is still a buyer's market**
- **It's time to stock pick; look beyond low valuations to receivables and cash balances**
- **Koreans benefit from strong exposure to offshore and LNG business; prefer SHI, upgrade to OW(V) from N**

Sentiment vs fundamentals. The sector underperformed the KOSPI by 29-34% in 2H11 due to weak order momentum and global macro concerns. While investor sentiment suggests the sector has bottomed, we don't think the industry fundamentals support this view as most indicators are not improving and the global macro outlook remains gloomy. This means stock selection has become more important and we suggest investors focus on news flow, payment delays and cash levels rather than just low valuations.

Offshore the key. We believe Korean yards are better positioned than their Asian peers as they have more exposure to the robust offshore and LNG business. But these factors alone will not be enough to turn the tide. We see no reason to turn bullish on the sector as a whole until fundamentals improve through higher vessel prices, stronger order volumes and a better financing environment. We urge investors to be more selective in 1H12 as shipbuilding is still a buyer's market and offshore production orders should be the difference between winners and losers.

Prefer Samsung Heavy (SHI), upgrade to OW(V) from N. We believe SHI is strong in offshore and LNG, is the only shipbuilder likely to achieve more than its new order target and has lower risk from long-term account receivables. We are Overweight (V) on Mipo and Neutral (V) on Hyundai Heavy (HHI), Daewoo Shipbuilding (DSME) and Rongsheng. We now apply IFRS to our models and change our target prices accordingly – SHI to KRW38,000 from KRW33,000, HHI to KRW320,000 from KRW350,000, DSME to KRW27,000 from KRW30,000, Mipo to KRW135,000 from KRW140,000, and Rongsheng to HKD2.5 from HKD3.5. Our target prices for HHI and SHI are 25% and 10% below market consensus, respectively.

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Investment summary

- Sentiment has bottomed but it is too early to turn bullish without better vessel pricing and volumes
- It's time to stock pick; macro news flow should provide trading opportunities
- Remain cautious; upgrade SHI to OW(V) from N; maintain OW(V) on Mipo, N(V) on HHI (adding V flag), DSME, and Rongsheng

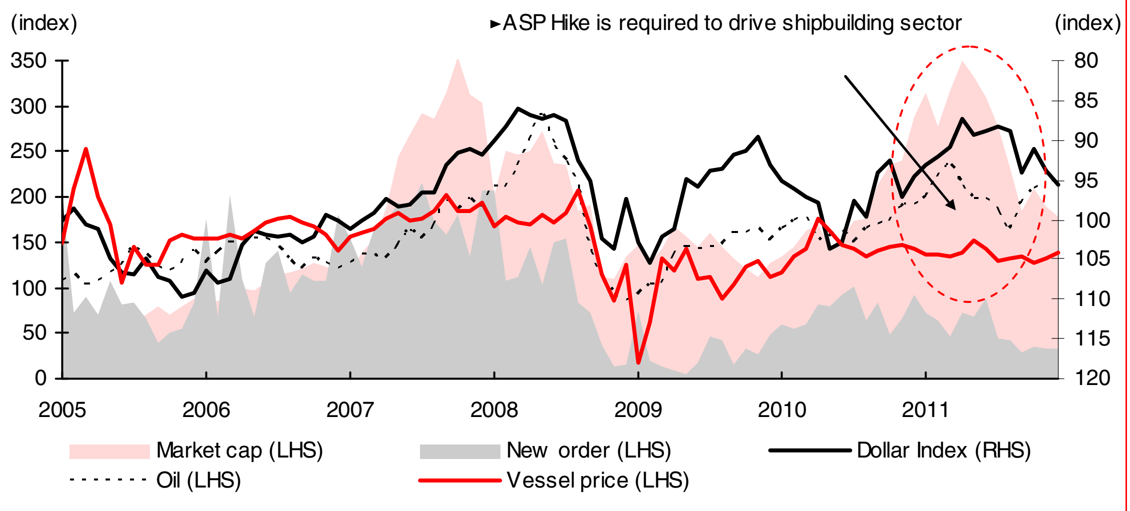
Sentiment vs fundamentals

We remain cautious on the sector. It underperformed in 2H11 and although the share price weakness has reduced expectations, we believe that investor sentiment may have bottomed. But we are not sure that the fundamentals support this view as most indicators are not improving and the global macro outlook remains gloomy.

In 1H11, the shipbuilding sector recovered slightly, mainly driven by strong demand for large containers, LNG carriers (LNGC) and offshore rigs such as drillships. While orders slowed 50% in 2H11, compared to 1H11, we expect strong LNG and offshore demand to continue in 2012.

However, we would not view this recovery as cyclical, as we saw in 2005-07. We expect global new orders to decline by 13% to 24.4m CGT in 2012. While we think new order targets are achievable, volumes and pricing are not strong enough to change the current market dynamics.

Shipbuilding cycle trends



Source: Bloomberg, HSBC

Many concerns remain, such as the profitability of current new orders, overcapacity, newbuild price and weak freight rates.

Also, we don't think LNG exports from the US, a potential catalyst, is a 2012 story. So far, six companies have applied for permission to export LNG, with a cumulative capacity of almost 2,900 billion cubic feet (bcf) per year or just over 12.5% of current US production. Of these, only Cheniere Energy has received Department of Energy (DoE) approval to export natural gas to non-free-trade countries. However, the project is unlikely to get a construction permit until the impact on domestic gas prices has been reviewed. This suggests the LNG story in the US is not a 2012 story, more like 2014.

Don't be fooled by valuation

Korean shipbuilders underperformed the KOSPI by 29-34% in 2H11. Despite this sharp correction, enterprise (EV) to backlog ratios and PB valuations still remain above Lehman crisis levels and their five-year-average. Along with the fall in earnings forecasts, fair values are being driven down by increased risks related to the uncertain economic outlook which has raised the cost of capital.

Korean shipbuilding stocks have been range-bound and while this may provide trading opportunities it is a trend that could last a lot longer than many expect, in our view.

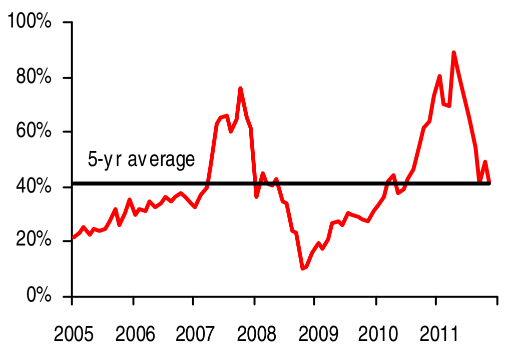
To us, the recent share price correction again demonstrates that the shipbuilding sector does not move purely for valuation reasons when the market is volatile. We believe valuations are often ignored by investors once the sector gains strong momentum in either direction.

Proposed North American LNG export projects

Project	Owners	Location	Terminal	Volume	Status
Sabine Pass Liquefaction	Cheniere Energy	Louisiana	Sabine Pass LNG	803	Received conditional DOE approval to export to both FTA and non-FTA countries. Application is pending with FERC.
Freeport LNG Expansion	ConocoPhillips, others	Texas	Freeport LNG	511	Received conditional DOE approval to export to FTA countries, but approval pending to non-FTA countries.
Lake Charles Exports	Southern Union	Louisiana	Lake Charles	730	Received conditional DOE approval to export to FTA countries, but approval pending to Non-FTA countries
Carib Energy	Carib Energy	Not applicable	Not Applicable	12	Received conditional DOE approval to export to FTA countries in South America, Central America, and the Caribbean.
Dominion Cove Point	Dominion Resources	Maryland	Dominion Cove Point LNG	365	Application to export to FTA countries is pending with DOE
Jordan Cove Energy	Fort Chicago and Energy Projects Development	Oregon	Jordan Cove	438	Application to export to FTA countries is pending with DOE
Kitimat LNG	Apache, EOG Resources, Encana	British Columbia, Canada	Kitimat	468	Approved by Canada's National Energy Board
BC LNG	LNG Partners HN DC LNG	British Columbia, Canada	New Construction	86	Applied to Canada's National Energy Board (Pending)

Source: US Department of Energy

Korean Big 3 EV to backlog trend



Source: Company data, HSBC

Valuations are still around 20-30% higher than the trough in 2009, mainly due to asset revaluation by HHI and DSME. This makes price to book value lower than in 2009 and some believe this could be the right time to accumulate these cyclical stocks.

We are not so sure. Although the high volatility, weak sentiment and lower valuation provide trading opportunities from a technical perspective, we do not expect many catalysts or much momentum in 1H12. This is because there has not been any improvement in the big sector drivers such as new orders, vessel prices and financing.

Higher prices needed to boost ROE

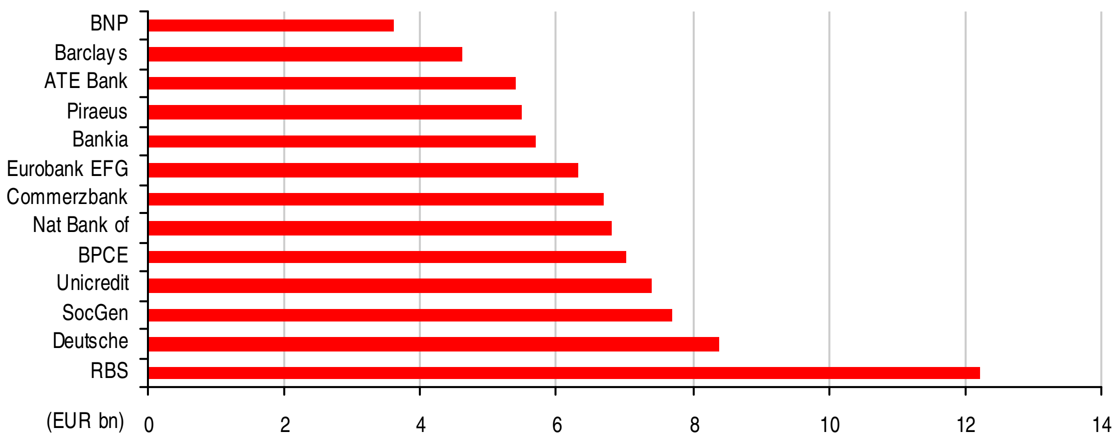
Shipbuilding stocks have a stronger correlation with industry indicators such as backlog, new order volume, vessel prices and freight rates than current earnings. As such, the lack of new order momentum in 1H12, depressed vessel pricing and the weak financing environment should provide downside risks to the rally orders in 1H 2011.

It is difficult to estimate the projected margin from new orders at the time the orders are placed. One of the easiest ways to check the direction of profitability is the price of vessels, which can enhance sector ROE. Recent ASP trends in most sub-sectors are either declining or moving sideways, driven by weaker financing, the uncertain economic outlook and stronger competition.

Only the LNGC segment may post ASP improvement on the back of strong charter rates. However, this alone cannot protect the margin for shipbuilders and it is still not certain that profitability will hit the bottom in 2012.

The biggest sector driver would normally be new orders but we think vessel pricing will be the most important factor in the current downcycle. We did not see any meaningful ASP increase for most types of vessel in 2011. Shipbuilders not only

Expected asset impairment of European banks



Source: Reuters.

offered lower prices but also attractive payment terms to secure new orders.

ASPs generally tend to follow the overall market volumes but despite a strong recovery in 1H11, even an inflationary environment has not led to higher pricing. We do not expect pricing to rebound soon as the correlation between weaker financing and pricing is increasingly important for most customers, given the uncertain outlook.

Impact of weak EUR on ASP

Shipping and shipbuilding is a USD-denominated business. Geography is irrelevant no matter where owners are based as both income and expenses are in USD.

It's a different story for the international banks whose loan volumes are dependent on the US dollar exchange rate and whose funding is in large part in local currency.

The USD/EUR rate has now reached almost USD1.30 from USD1.44 in 2Q11, due to European sovereign debt crisis. This has led to a deterioration in the purchasing power of European ship owners.

Interestingly, new build prices for ships were at a record high during 2008 when the EUR reached its peak (see chart below).

Payment problems

It appears that the shipyards are experiencing payment delays from struggling ship owners even on vessels already delivered. In some cases the yards have agreed to payments being spread over 3-5 years.

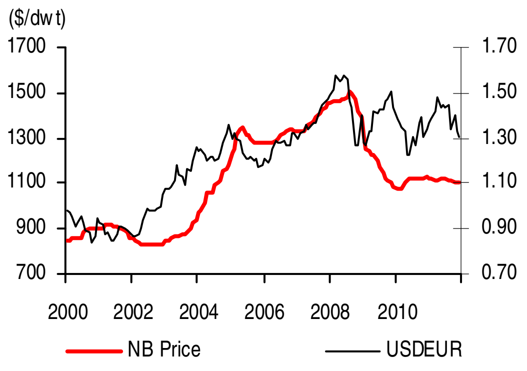
This is surprising as it did not happen back in the crisis days of 2009. We cannot check exactly how much this effects under-construction and already-delivered accounts but by looking at the operating cash flow and net debt trend we believe further deterioration is unavoidable in 2012.

Korean shipyards have been generating good cash flow based on orders secured in the boom times of 2005-07. Balance sheets and dividends have been healthy in the past 2-3 years. However, the recent decline in new orders and the inability to make new investments have eroded shareholder value.

As of 3Q11, net debt to equity deteriorated to 51.5% from 35.8% at the end of 1Q11. Among big 3 in Korea – HHI, SHI, DSME – DSME has suffered the most.

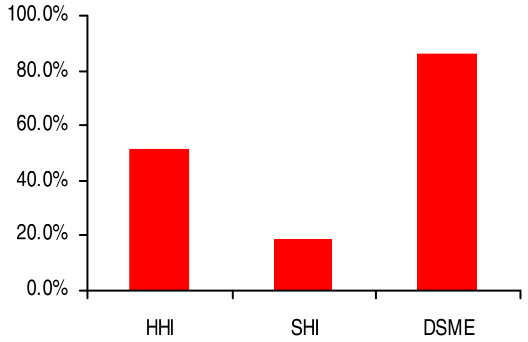
We expect cash flow to continue to be eroded in 2012, with increased net debt. Margins are falling due to delivery delays, more lower-priced vessels, a higher fixed-cost burden and relatively higher raw material prices. The combined effect would inevitably mean a contraction in ROE.

USDEUR vs. New-building price



Source: Bloomberg, Clarkson

Korea Big 3 Shipbuilder: Net debt to Equity



Source: Company data as of 3Q11

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Can offshore save Korea's big 3?

With strong oil prices, attractive yard newbuild prices and contract day rates starting, long-term demand for deepwater drilling units is likely to remain strong. The E&P sector overall is, we think, in a much better position than it was in 2008-09 – companies seem to have learnt not to rely on a continually increasing source of liquidity to meet their commitments, and overall we do not think the "financing" angle will derail growth.

Deepwater (specifically ultra-deepwater) markets are still absorbing new supply but have already managed to post improvements in contracted rates (with some contracts already rolling over or being set higher than USD500,000/day). We think further improvements in deepwater day rates could well be visible in contracts in 2012 – as ever, potential demand from Brazil remains the largest "moving part" that could accelerate this picture.

The outlook for orders across offshore categories is, we think, quite positive over the next few years, but the mix is likely to be different:

- **Jackup rigs** – the "fleet renewal" trade should continue and we expect to see a significant number of orders as the drilling industry upgrades its existing (old) fleet. This is likely to prove good news for the specialised Singapore yards, some Chinese yards and also Middle Eastern facilities like Lamprell (playing their cost advantage).
- **Floater rigs** – after the wave of drillships in 2010-11, we expect more of a balance between orders for semi-submersibles and drillships in 2012-13. Brazil remains the single largest moving part, with its ongoing tender for 21 new deepwater units to be built in Brazil itself. The winners from this are likely to be the mainstream Korean yards (for business with international drilling contractors in particular), but we note that the single largest tender for newbuilds is focused on Brazilian construction.
- **FPSOs** – we expect conversion work to pick up over the next few years, which raises the question as to whether there is enough yard space in Singapore to handle this specialised work (although some work will likely relocate back to Brazil over the longer term). We expect more early-stage conversion work (not modules or integration) going to Chinese and other yards where there is capacity to ease the bottleneck (we believe the mainstream FPSO specialists are already examining this closely). Newbuild work will also likely see decent activity, we think, which is likely to fall to the Korean yards (as is further work around floating LNG – FLNG).

Despite the long-term positive outlook, the stand-alone offshore demand makes us wonder if this sub-segment can save the overall shipbuilding industry and enhance the earnings profile dramatically. The current strong exposure to drillships should not be enough to improve both top and bottom line growth for Korean shipbuilders, rather they would expand into some other areas, including subsea or engineering, where European names are still dominating, with high entry barrier due to regulation and safety issues.

Drillship new orders in 2011

(Unit)	New order	Option	Chartered	Speculative	% Chartered
HHI	11	1	5	6	45%
SHI	10	7	0	10	0%
DSME	5	2	0	5	0%
Total Korean yards	26	10	5	21	19%
Global new orders	**33**		**12**	**21**	**36%**

Source: Rigzone, Clarkson, Company data, HSBC

Besides, we still believe that many offshore projects will be delayed further for various reasons (see the table below).

In 2011, out of 33 orders for drillships 26 went to Korean shipbuilders, representing a global market share of nearly 80%. We expect new orders for offshore drilling rigs to slow to 15-20 units in 2012, Korea's Big 3 have set a 2012 new order target of USD54.1bn, up 10% from 2011 but down 11% from the actually secured orders in 2011. We believe they will have to clinch several new offshore orders to achieve their 2012 new order targets.

According to HSBC oilfield service research, FPSO demand is likely to increase in 2012. However, as most of the upcoming projects are likely to be relocations or conversions, not newbuilds, Singapore or Chinese yards could benefit more than Korean yards. On the other hand, we expect Korean shipbuilders to benefit from the increasing demand for offshore LNG production units, especially Samsung Heavy, due to their strong track record and higher exposure to potential projects

Asset values under pressure

Cash operating costs for rigs have gone up 11% per year since mid-2007 and we think this could have a 10-15% impact on rig operators' earnings, depending on the age of their fleets. This implies that customers will increasingly prefer the second hand market to new vessels.

Rig owners also believe the current new-build pricing is expensive and have put expansion plans on hold due to the rising cost of building platforms. Thus, we may continue to see weaker new-build pricing as well as Asian yards having less bargaining power, so expect no improvement in the big sector drivers such as new orders and vessel prices.

Ongoing offshore projects

Country	Project	Developer	Type	Vessel	FID	Status
Australia	Ichthys	Inpex	Gas Condensate	CPF FPSO Onshore	1Q12	* The marketing was completed recently * FID is expected to complete in 2012 * Supply 2m ton per annum to KOGAS
	Sunrise	Woodside	Gas	LNG FPSO	Unlikely in 2012	* Gas reserve is located in a disputed area where the borders of East Timor and Australia overlap * Issues remain unresolved as Australia prefers a FLNG project, while East Timor wants to build a PLNG project with a gas terminal within its borders. * Korea Consortium consisting of KOGAS and Samsung C&T has a partnership with East Timor. * Unlikely to complete FID within 2012
	Browse	Woodside	Oil	Fixed Platform	Unlikely in 2012	* FID is likely to delay to 2013 or later
Malaysia	Petronas	Petronas	Gas		Unlikely in 2012	* Even a target gas reserve for the project has not been decided * Petronas is likely to delay FID to 2013 or later
Papua New Guinea	InterOil	InterOil	Gas	LNG FPSO	Unlikely in 2012	* The reserve is lucrative enough but… * Currently there are lots of problems in development planning * Unlikely to complete FID in 2011
	PNG FLNG	Petromin	Gas	LNG FPSO	Uncertain	* How lucrative the reserves will be is unproven * Difficult to develop in the near term
Russia	Shtokman	Gazprom	Gas	FPU	Unlikely in 2012	* Huge amount of reserve and well-established partners but… * The project is likely to be delayed due to cash issues * 1st stage: Pipeline project - FID likely to be completed in 2012 * 2nd stage: LNG project - it needs more time.
Nigeria	Egina	Total	Oil	FPSO	2Q12	* FID is expected to complete within this year
	Brass LNG	Brass LNG	Gas	Fixed Platform	Unlikely in 2012	* Delayed due to political issues and low reserve
Vietnam	Block B	Chevron	Gas	Fixed Platform	2012	* FID is expected to complete within this year
UK	Western Isles	KNOC	Oil	FPSO	2012	* FID is expected to complete within this year
Congo	Moho Nord	Total	Oil & Gas	TLWP	2013	* Preferred bidder will be selected within 2012, but FID is likely to delay

Source: Company data, Ship news, HSBC

Time to look at 2014 backlogs: not enough to become seller's market

With the average order backlog at 2.5 years at the beginning of 2012, shipbuilders need to fill 2014 slots in 1H12. However, with weak new orders, tough financing conditions and project delays, we do not believe order volume is strong enough to change the current market dynamics. In short, we believe it's still a buyer's market.

While in our view Chinese yards can't match the quality of Koreans when it come to building drillships, LNGCs and large container vessels, our industry channels suggest new orders will decline in Korea in 2012 after the strong intake in 2011. We think the current trend of drillship and container orders is not sustainable and we believe Chinese yards will be more aggressive in terms of taking new orders with a shorter backlog period.

Stock picks

1. Hyundai Heavy: N(V), TP KRW320,000

- Maintain Neutral (add V flag) due to weakening industry demand and unfavourable macro environment.
- Diversification cannot protect the downside risk due to margin contraction at non-shipbuilding division, in our view.
- Relatively weaker exposure to LNG.

2. Samsung Heavy: OW(V), TP KRW38,000

- Upgrade to Overweight (V) from Neutral due to strong competitiveness in offshore and LNG segment and lower risk of payment delay.
- The only shipbuilder likely to achieve its annual new order target on the back of strong exposure to offshore and LNG-FPSO, in our view.
- Deserves a premium in our view; trading at similar valuation level without asset revaluation vs. HHI and DSME.
- Our top pick in the sector.

3. DSME: N(V), TP KRW27,000

- Maintain Neutral (V) and lower PB-based TP to KRW27,000 from KRW30,000, due to lower ROE.
- Strong offshore and LNG segments offset the lacklustre commercial vessel market.
- Margin contraction to continue until 2012e, along with earnings risk from several delays in payment contracts.

4. Hyundai Mipo: OW(V), TP KRW135,000

- Deep discount to NAV.
- Weaker industry exposure and direct competition with Chinese yards.
- Reiterate OW(V); limited downside risk at the current share price offering 24% potential return.

5. Ronsheng: N(V), TP HKD2.5

- Maintain Neutral (V) on execution risk and higher exposure to bulker and tankers.
- Aggressive and ambitious expansion means the cash cycle has not yet turned, something that needs to happen for the company to gain the confidence of investors in our view.
- We believe the street is overly optimistic on new orders and earnings.

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Valuation and risks

- Don't be fooled by valuation – more time needed to reach the inflection point
- Revisit our estimates based on IFRS from K-GAAP parent basis
- Upgrade SHI to OW(V) from N; maintain OW(V) on Mipo, N(V) on HHI, DSME and Rongsheng

Although sentiment seems to have bottomed, we still have a cautious view of the Korean shipbuilding sector. We strongly believe that it will take more time for the industry to reach the inflection point and enter a cyclical upturn.

Despite high expectations for the offshore and LNG segment, the overall industry earnings declined gradually in 2011 and we expect to see further earnings downside in 2012, which could be key driver of ROE contraction for shipbuilders.

Korean shipbuilders have been range-trading recently. We believe weak industry fundamentals are reflected in the share prices, but cheap valuations provide good trading opportunities, depending on new orders, the seasonal effect of commodity prices, macro events and freight rates. Therefore, we think the stocks will trade in a valuation range of between 0.9x and 1.2x PB until we see a strong turnaround in industry fundamentals.

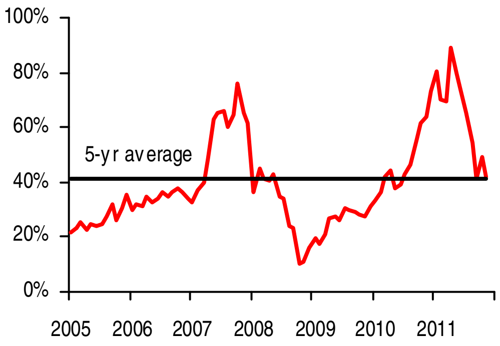
In terms of EV to backlog valuation, despite the recent correction, EV/backlog still remain above both the post-Lehman crisis level and the 5-year average. We agree that this is not an exact measure of the cycle as it shows market expectations on future new orders. Historically, Korean shipbuilders have traded at 39% EV/backlog in the past five years. This compares with a peak in the last cycle (2006-07) of around 77% (and an average of about 45%).

However, we think Hyundai Heavy does not truly reflect its shipbuilding cycle as the stock was re-rated in 2010-11 due to its diversified business.

Therefore, given weaker new orders and sustainability, we believe that shipbuilders' cyclical upturn is some way off mainly due to:

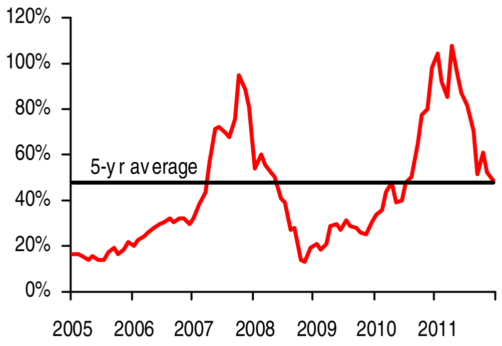
1. The sector fundamentals are showing no signs that the stocks are reaching an inflection point.
2. The lack of catalysts for the next six months.
3. Intensifying competition, especially from Chinese yards.

Korea Big 3: EV to backlog trend



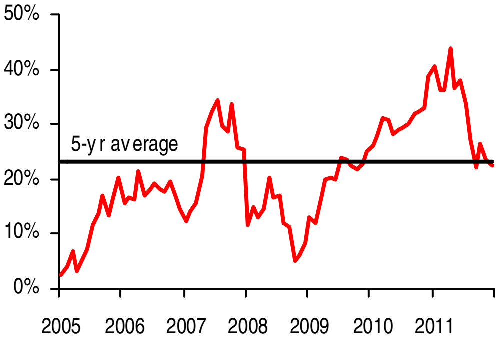
Source: Company data, HSBC

HHI: EV to backlog trend



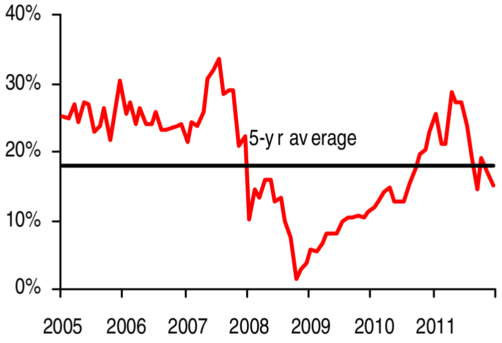
Source: Company data, HSBC

SHI: EV to backlog trend



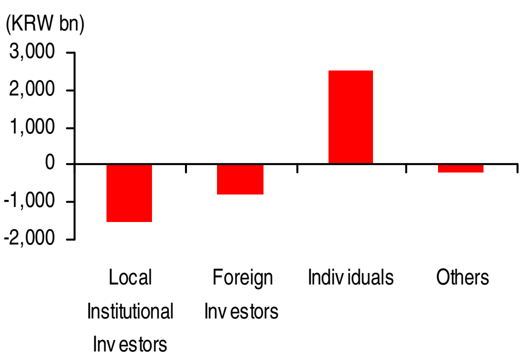
Source: Company data, HSBC

DSME: EV to backlog trend



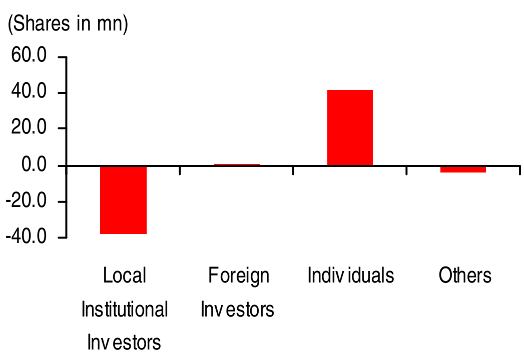
Source: Company data, HSBC

Korea Big3 Shipbuilders: Net bought in KRW term in 2H11



Source: KRX

Korea Big3 Shipbuilders: Net bought in number of shares in 2H11



Source: KRX

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Valuation methodology

Given the cyclicality of the shipbuilding business, we believe the asset-based PB approach is appropriate as it reflects the prevailing risk appetite towards the industry. By looking at the relationship between ROE, historical ROE and the relevant PB multiples, we derive an appropriate multiple to reflect the current stage of industry development. However, we use sum of the parts valuation for HHI and Mipo in order to reflect their diversified business nature and larger non-core asset value.

We then divide implied ROE by COE to derive an implied PB ratio. We assume terminal growth of 0% for Korean yards and 3% for Chinese yards. Within the shipbuilding sector, as capital structure and tax rates are similar, operating margin is a decisive factor in determining ROE.

To factor in the cyclicality of the shipbuilding business, we look at a historical chart showing how the valuation of the Asia shipbuilding sector tends to track new contracts. Since 2003, it indicates a positive correlation coefficient of 49.7% (R square of 24.6%) between the two variables. In the most recent period, both peaked in 2H07 before falling sharply in 2H08. As global new contracts slightly declined 29% y-o-y to 26.1m DWT in 2011, shipyards were also trading at low multiples. Looking ahead, we are expecting global new orders to remain almost flat at 24.4m CGT in 2012, which is still below global capacity at roughly 44m CGT.

Shipbuilding stocks are more highly correlated with other industry indicators, such as backlog, new order volume, vessel prices and freight rates, rather than the current earnings. As current new orders indicate earnings for 2014 and beyond, the recent trend in new orders reflects the true value of shipbuilders.

In 2011, the shipbuilding industry continued to recover in new orders, especially in the offshore and LNG segment. However, volume and ASP are not sufficient to signify a further upcycle, in our view. Therefore, despite the lower valuation and bottoming sentiment, we urge investors to wait for signs of fundamental improvement such as vessel price hikes and more frequent new orders.

IFRS conversion

We have revisited our estimates due to the switch to K-IFRS from K-GAAP. We now forecast sales numbers on a K-IFRS consolidated basis. Estimates for Hyundai Heavy now include affiliates such as Hyundai Samho and Oilbank, leading to a huge increase in its sales and operating profit.

By adopting IFRS, changes in consolidation range lead to an increase in book value, which makes shipbuilders' PB more attractive. However, this simply reflects the change in accounting standards. We adjust for this when deriving our target multiple derived from the sustainable ROE.

Stocks

HHI – SOTP TP KRW320,000

For HHI, we change assumptions under our SOTP valuation and the lower the target price to KRW320,000 from KRW350,000. We believe SOTP is an appropriate valuation method given HHI's divisional structure, broad mix of activities and various investment assets. This does not apply to a pure play such as SHI. Under our new HHI SOTP valuation, we include HHI's investment assets, and apply 5.0x EV/EBITDA multiples to each business division.

HHI: Valuation summary

Operating Asset value (KRWbn)	**23,387**
EV/EBITDA multiple (x)	5.0x
2012e EBITDA (KRWbn)	4,665
Non-operating asset value (KRWbn)	**3,360**
2012e Net debt (KRWbn)	**7,083**
Equity value (KRWbn)	**19,664**
Shares outstanding (million shares)	61.3
Target price (KRW)	**320,000**

Source: HSBC estimates.

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SHI – PB-ROE TP KRW38,000

Our PB-based target of KRW38,000 (up from KRW33,000) is derived by applying a 1.5x PB multiple (sustainable ROE: 14.0%; COE: 9.1%; and g (long-term growth): 0%) to our 2012e book value, reflecting the cyclical nature of the shipbuilding industry.

SHI: Valuation summary

2012e BVPS	24,324
Target PB	1.5x
COE	9.1%
Sustainable RoE	14.0%
Target price (KRW)	38,000

Source: HSBC estimates.

DSME – PB-ROE TP KRW27,000

Our PB-based target of KRW27,000 (down from KRW30,000) is derived by applying a 1.0x PB multiple (sustainable ROE: 11.9%; COE: 11.8%; and g (long-term growth): 0%) to our 2012e book value, reflecting the cyclical nature of the shipbuilding industry.

DSME: Valuation summary

2012e BVPS	27,428
Target PB	1.0x
COE	11.8%
Sustainable ROE	11.9%
Target price (KRW)	27,000

Source: HSBC estimates

MIPO – SOTP target at KRW135,000

We reiterate our Overweight (V) rating on Hyundai Mipo but lower the target price to KRW135,000 (from KRW140,000) based on sum-of-the-parts valuation. Under our SOTP valuation, we apply zero operational value to its commercial shipbuilding due to weak industry trends on bulkers and tankers. We believe SOTP is an appropriate valuation method given Mipo's various investment assets.

In our NAV calculation, we value its core operations at zero. We apply a 50% discount to the non-core assets (KRW2.0trn), including the equity-method requirement for subsidiary value and holdings of marketable securities, in order to reflect the effect from the corporate tax when liquidated. Lastly, we add estimated 2012e net cash of KRW606 bn.

Mipo: Valuation summary

Operating asset value (KRWbn)	**0**
EV/EBITDA multiple (x)	0.0x
2012e EBITDA (KRWbn)	208
Non-operating asset value (KRWbn)	**2,042**
2012e Net debt (KRWbn)	**-606**
Equity value (KRWbn)	**2,647**
Shares outstanding (million shares)	19.6
Target price (KRW)	**135,000**

Source: Company data, HSBC estimates.

Rongsheng – PB-ROE target HKD2.5

We maintain N(V) on Rongsheng with a PB-based target price of HKD2.5 (down from HKD3.5), derived by applying a 0.7x PB multiple (sustainable ROE: 12%; COE: 15.1%; and g (long-term growth): 3%) to our 2012e book value, reflecting the cyclical nature of the industry. We think PB-ROE valuation is appropriate given its 95% exposure to the shipbuilding segment.

Rongsheng Heavy: Valuation summary

2012e BVPS (RMB)	2.78
HKD/Rmb	1.22
2012e BVPS (HKD)	**3.39**
Target PB	0.7
COE	15.1%
Sustainable ROE	12.0%
Growth	3.0%
Target Price (KRW)	**2.5**

Source: Bloomberg, HSBC estimates.

Conclusion

Despite the recent correction and investor sentiment hitting the bottom, we think it is unlikely that our stocks will reach the inflection point soon. The bull camp may argue that valuations look super cheap compared to the last super cycle, but more fundamental improvement is required to drive the sector.

Industry dynamics show that Koreans enjoyed strong order momentum from sub-segments in 2011 – container, offshore and LNGC – where

they have higher exposure on the back of strong commodity demand and delayed orders due to the financial crisis. However, increased competition and low ASP could cause ROE to trend lower going forward.

Sector risks

Upside risks include: 1) a sharp global economic recovery leading to pick up in new orders; 2) a newbuild price rebound with stronger than expected order volume; and 3) stronger commodity prices with better than expected offshore orders.

Downside risks are: 1) continued oversupply further delaying of new order recovery; 2) slower macro recovery; 3) stiffer competition from Chinese yards; and 4) any changes in the E&P regulatory or operating environment.

Industry overview

- Still no signs of recovery in bulkers and tankers, containers
- LNG & offshore could offer upside potential; however they cannot provide cyclical upturn in 1H12
- Be more selective as we believe offshore production will decide the winners and losers within the sector

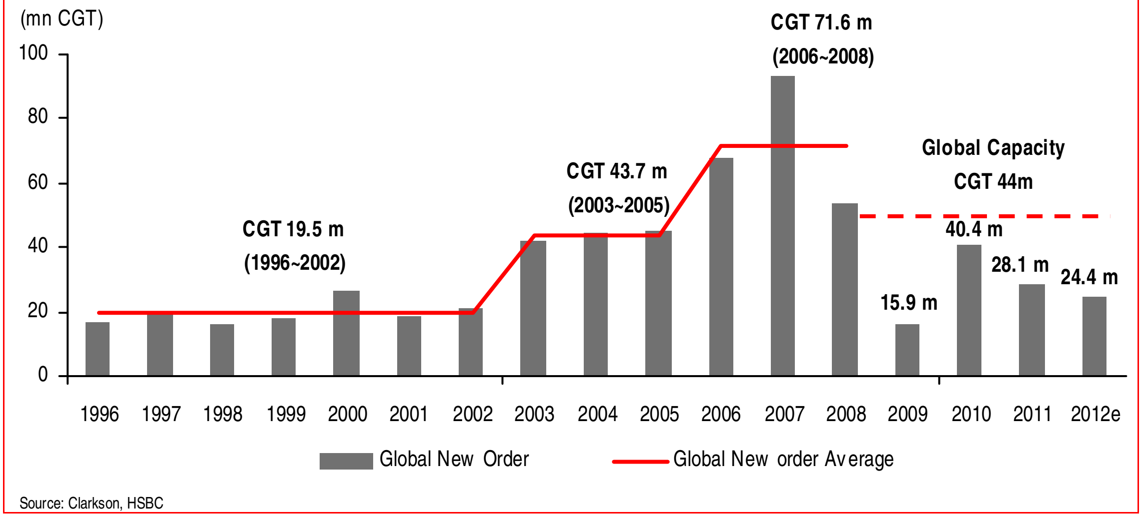
No further recovery from here

In 1H11, the shipbuilding sector recovered slightly, mainly driven by strong demand for large containers, LNG carriers and offshore drilling rigs. However, shipbuilders underperformed in 2H11 as new order momentum slowed down in containers and drillships. We expect strong demand for LNGC and offshore vessels to continue in 2012. Unlike 2011, however, offshore production units such as Oil/LNG FPSOs, FPUs and platforms are likely to gather new order momentum, given various upcoming projects.

However, we would not view this recovery as cyclical, as we saw in 2005-07. Many concerns remain, such as profitability of current new orders, overcapacity, newbuild price and weak freight rates.

We expect new orders to decline by 13% to 24.4m CGT in 2012e. We believe recent strong orders from offshore and LNG do not point to another strong cyclical upturn as we saw during 2006-08. Also, the absolute demand number at 24.4m CGT is still well below global capacity of about 44m CGT and is likely to restrict shipyards' bargaining power. We believe new orders will move sideways in 2012 and it will need more time to reach an inflection point.

Global new order demand vs. capacity



Source: Clarkson, HSBC

In terms of orderbook to fleet, LNGC is the lowest at 17.2%, following by tankers, containers and bulkers. We believe LNGC new orders remain strong in 2012, given its lower orderbook and higher charter rate. In this regards, we prefer the LNG segment most over other commercial vessels.

Bulkers

HSBC's shipping research (sourced from *Asia Dry Bulk* report published on 6 December 2011 by Shishir Singh) noted that the over-capacity issues are likely to lead to lower bulk rate, despite the steady demand for transporting commodities.

We estimate that the pressure on fleet utilisation will continue to grow over the next 12 months due to continued new deliveries. While the Handysize segment (smaller vessels of 10,000-40,000 DWT) is in a better position, the dry bulk market as a whole has to digest new supply equal to that of the last decade within five years (mostly 2011-13e). The sector-wide order book was 53% of fleet size at the start of 2010 and remains at an uncomfortable 38% at the end of October 2011

Given that sector supply has increased by almost 50% in the last three years, it is hardly surprising that utilisation is now set to dip below 80% in 2011 from the mid-1990s level prior to the financial crisis in 2008. The employment of new supply at profitable rates will be challenging in an environment already characterized by the lowest utilisation in this millennium.

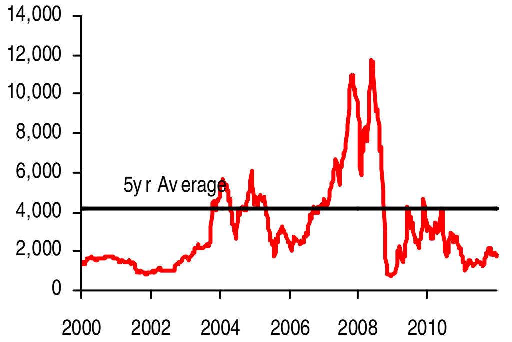
Consequently, we expect both scrapping and order cancellations to pick up pace in 2012, but still expect supply growth to exceed demand growth, worsening the already weak fundamentals. That said, we view handysize as a more defensive segment since its orderbook is the lowest and its fleet age is the highest. Consequently, handysize supply should remain stable beyond 2011, but supply in other segments is likely to grow at a CAGR of 5-10% over the next two years.

We maintain our demand growth forecasts of 5-6% in 2012-13 including the tonne-mile impact. Chinese steel demand should be the single most important swing factor for dry bulk trade demand.

The team expects demand from the rest of the world to support global trade for iron ore. Of course, there is a risk that real demand growth could turn out to be weaker than expected if the economy falters and global steel production declines.

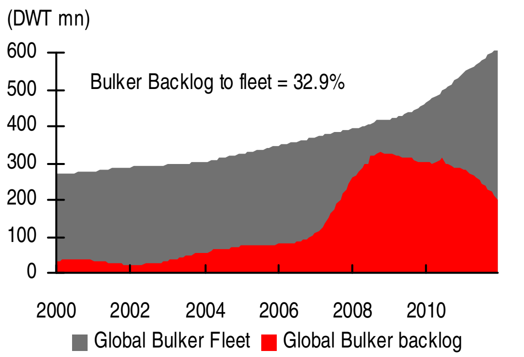
As of the end of 2011, global dry bulk fleet consisted of 8,890 vessels or 611m DWT with the orderbook at 213m DWT, equivalent to 32.9% of the existing fleet. As per Clarkson, 138.9m DWT is scheduled for delivery in 2012 and 50.5m DWT in 2013.

BDI Index trends



Source: Bloomberg

Global bulkers backlog to fleet



Source: Clarkson

Iron ore market outlook by HSBC's metal and mining team

Summary

- The iron ore market has been rescued by lower Indian exports this year, and spot prices remain high
- We do not see a definitive turn in fundamentals until 2014, although the market should be more balanced in 2013
- We are retaining our 2012 forecast of USD140/t (Aust. FOB fines).

Supply

- Waning Indian exports have saved the market this year in our view – supporting spot markets into 4Q and guaranteeing a good start to 2012. HSBC Economics forecast Indian net exports will continue to decline through 2015.
- HSBC's Metal and Mining team have increased our forecast for production from FMG in Australia to 100mt in 2013 (from 60Mt) and 140mt in 2014, and the growth of this emerging Australian producer should be a key swing factor in the market in the next three years. We have cut our Chinese production estimates to reflect lower prices in 2014-15, and still see the market challenged by low grades and declining quality of ore. We believe the iron content of ore produced will stabilise around 200mt/y, with about one-third of this with costs over USD120/t.

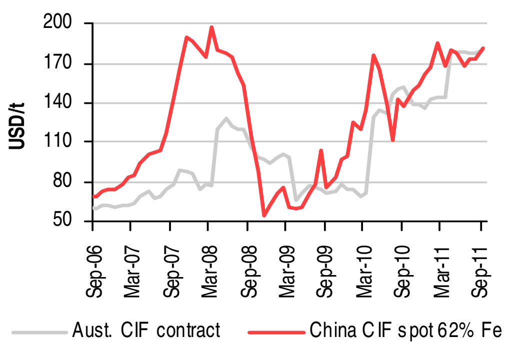
Demand

- Global crude steel production is expected to be 4.1% in 2012. This has structurally lowered our iron ore demand projections.
- We continue to look for signs from producers that order flow has been interrupted by recent macro-economic trends, but to date comments are being confined to "some rescheduling of orders" or "some delay before confirmation", with no producer to our knowledge yet talking about significant order deferrals.
- We continue to expect a moderation in demand growth following the significant 2009-10 cycle. In absolute terms, we expect iron ore demand to moderate to 85-110mt/y incremental demand in the forecast period.

Market balance/pricing

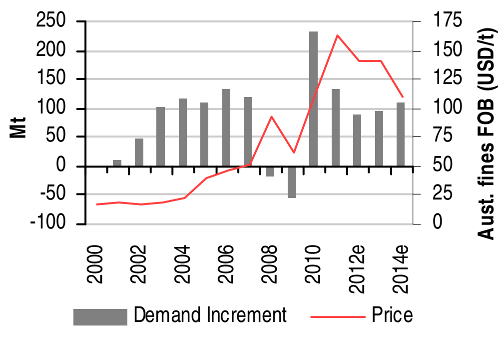
- We continue to expect prices to fall towards the cost of low-quality Chinese production over the next two years, as demand slows and production accelerates, but we do not expect this material to be pushed out of the supply chain before 2015 at the earliest.
- Of the 1.1bn Run of Mine (ROM) ore in China, we believe one-third has costs in the order of USD130/t, with the balance being better quality

Prices holding up, but likely to rediscover cost



Source: CRU, HSBC analysis

Demand increments will moderate



Source: HSBC world steel model, SBB, HSBC analysis

material or ore tied to a particular steel producer. We see cost support at USD110/t FOB for Australian fines, and see the market gravitating towards this level by 2013.

- Prices in the near term continue to be supported by low Indian exports – we expect softer demand to impact prices in 2012, but we have already factored this in and retain our 2012 forecast at USD140/t FOB fines.

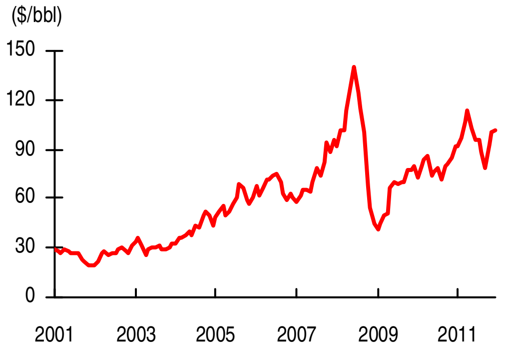
Tankers

Despite the strong oil price, tanker makers have been relatively quiet. The supply growth remained at roughly 10.5% in 2011; however the conversion of storage vessels increased its overall supply so we do not expect any recovery in this segment in 2012. We believe that once those converted vessels are fully in the market, the tanker market may rebound depending on the number of demolitions in 2012. We prefer offshore/LNG over tankers as we believe offshore is a leading segment indicator for tankers.

We think the recent rally in Brent over USD100 has been driven by short-term factors including politics, speculation and weak USD. HSBC oil & gas research team regards these issues as temporary or seasonal and in the short term does not see the current oil price as justified by fundamentals. From a longer term view, they believe the oil price should move to a normalised level. The team believes that in the medium term, crude prices are likely to return to the "OPEC preferred range" of USD80-100/bbl.

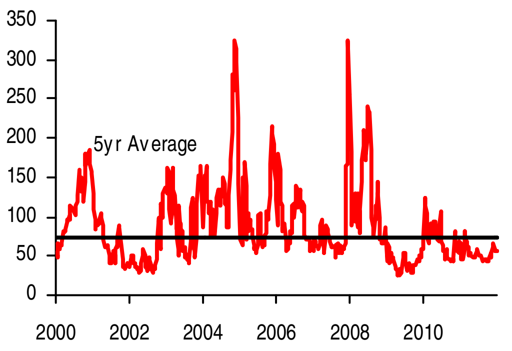
As of the end of 2011, the world tanker fleet (vessels above 10,000 DWT) consisted of 5,671 vessels or 476m DWT in capacity, with the order book standing at approximately 709 vessels or 84.7m DWT, equivalent to about 17.8% of the existing fleet. As per Clarkson data, 50.0m DWT is scheduled for delivery in 2012 and 28.2m DWT in 2013.

WTI spot price trends



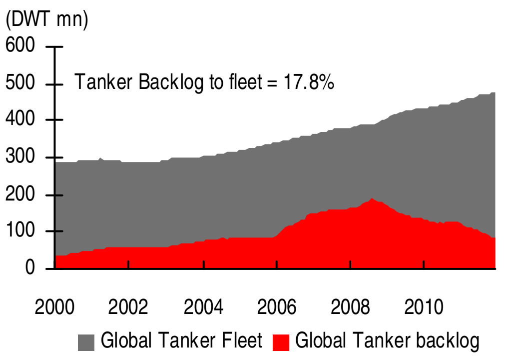
Source: Bloomberg

World Scale VLCC Asia gulf to Japan



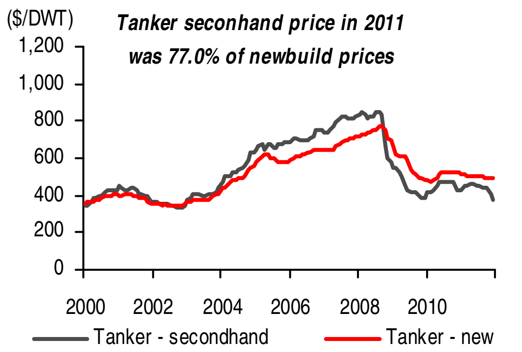
Source: Bloomberg

Global tankers backlog to fleet



Source: Clarkson

Tankers new building price vs. second hand price



Source: Clarkson

Containers

While other commercial vessel markets have remained sluggish since 2009, container earnings recovered faster than expected in the period of 2010-2011. However, spot freight rates have fallen 38% since August 2010, led by the Asia-Europe route (-66%). What was initially seen as a seasonal problem turned into a structural decline this year; there are also overcapacity fears as trade slows down, particularly on transpacific and Asia-Europe routes.

According to the HSBC Asia container shipping research team, given the decline in demand for consumer products in the western world, we estimate container shipping demand growth of 5% and 6% in 2012-13, respectively. We estimate that the effective container shipping fleet will grow 10% in 2012 and 16% in 2013 after taking into account delays in new deliveries and scrapping of older vessels. Our demand and supply forecast implies that supply will continue to exceed demand in 2011-12 and we expect the average freight rate will fall by 6% in 2011 and increase marginally in 2012.

Forecasting trade growth in 2011-12e requires a consideration of growth rates for global GDP, US and European consumer spending and China's exports.

Based on historical trade patterns and our own views, we have applied a multiplier of 2.4x and 1.9x in 2011 and 2012, respectively, to the world GDP forecast, which takes into account significantly weaker consumer spending in the US and Europe. It provides us with container trade growth forecasts of 6% in 2011 and 5% in 2012.

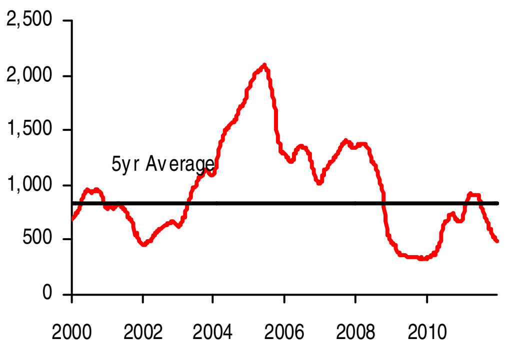
Global container demand forecasts

(m TEU)	2010	2011e	2012e	2013e
Global trade forecast	140.0	148.7	156.7	166.5
y-o-y change	13%	6%	5%	6%
CSCL	7.2	7.0	7.3	7.7
y-o-y change	7%	-3%	5%	6%
Evergreen	4.6	5.0	5.3	5.7
y-o-y change	7%	7%	6%	9%
NOL	5.7	6.0	6.2	6.7
y-o-y change	24%	5%	5%	7%
OOIL	4.8	5.0	5.2	5.6
y-o-y change	15%	6%	4%	6%

Note: For NOL we assume FEU/TEU multiple of 2x.
Source: Clarksons research services, company data, HSBC estimates

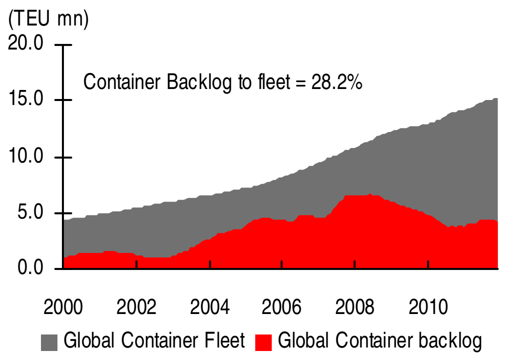
The 8,000+ TEU vessels constitute about 24% of the current fleet, over 70% of the total order book

HRCI Index



Source: KMI

Global containers backlog to fleet

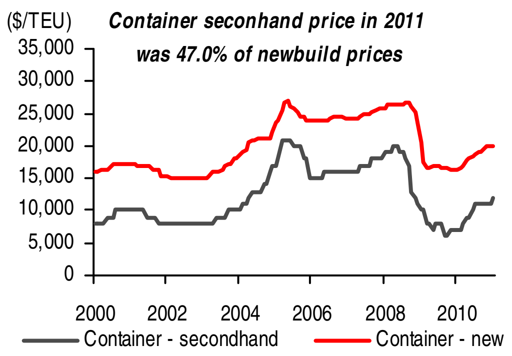


belongs to this category, indicating the current trend is to order large ships. However, we believe a pick-up in intra-Asia trade will not help to absorb the supply of the new larger vessels arriving in 2012-14. These vessels are built to carry goods for the deep sea East-West Trans-Pacific and Asia-Europe trades and are not economically suitable for shorter routes in Asia.

The actual delivery schedule suggests container capacity growth of 10% each in 2011 and 2012, assuming no scrapping, cancellation or delays. However, actual supply depends on scrapping, cancellation and deferral of vessels, idle capacity and slow-steaming.

As of the end of 2011, global container fleet consisted of 5,093 vessels or 15.3m TEU with the orderbook at about 4.3m TEU, equivalent to 28.2% of the existing fleet capacity. As per Clarkson data, 1,577.6k TEU is scheduled for delivery in 2012 and 1,653.8k TEU in 2013.

Container new building price vs. second hand price



Source: Clarkson

LNG carriers

The price difference between low US natural gas prices and high international markets has spurred interest in exporting US produced natural gas. After LNG pricing surged following the Japan earthquake in March, there has been increasing interest in LNG as natural gas emits much less carbon dioxide and other pollutants than coal.

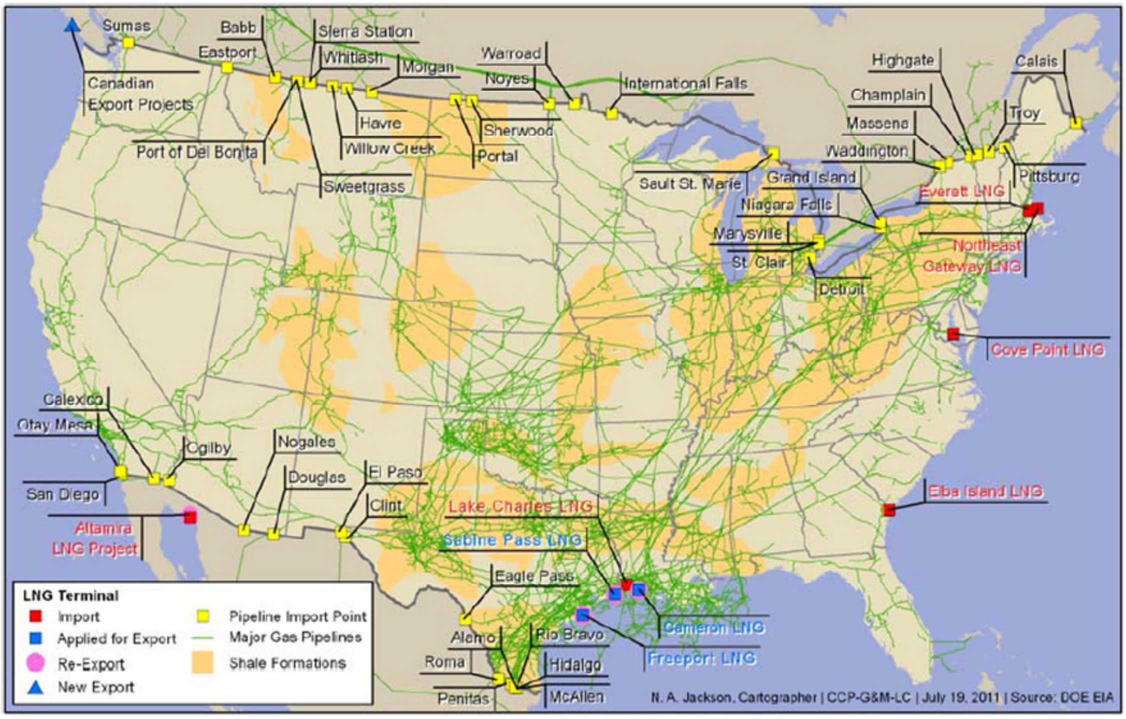
So far six companies have applied for permission to export LNG, with a cumulative capacity of almost 2,900 billion cubic feet (bcf) per year or just over 12.5% of current US production. Of these, only Cheniere Energy has received Department of Energy (DoE) approval to export natural gas to non-free-trade countries. However, the project is unlikely to get a construction permit until the impact on domestic gas prices has been reviewed. This suggests the LNG story in the US is not a 2012 story, more like 2014.

Looking longer term, if we assume all the projects were operating today, we think the market would need 67 LNG vessels. The bulk of the exports will go to Europe given that most of the proposed export terminals are on the US Gulf Coast and the East Coast. The Jordan Cove project in Oregon is targeting the Asian natural gas market.

Based on the current LNGC price of USD200m this trend could be worth as much as USD13.4bn to the industry. While Korean shipbuilders are strong in LNGC, the segment still accounts for only 14-18% of their annual new order targets. Besides, we do not expect Korea's big three to take all the LNGC orders. Chinese yards are likely to receive some from Chinese SOEs, including CNOOC, as well as others from an increasing number of price-sensitive international customers.

New orders tend to depend on buyers of long-term LNG contracts. For example, Korean shipbuilders received more LNGC orders in 1990s as KOGAS was a major LNG buyer.

US LNG export and import points



Source: US Congressional Research Service report

Charter status of LNGC ordered in 2011

(Unit)	New order	Option	Chartered	Speculative	% Chartered
HHI	12	2	4	8	33%
SHI	20	6	9	11	45%
DSME	12	6	5	7	42%
STX	3	3	2	1	67%
Total Korean Yards	47	17	20	27	43%
Global new orders	**54**		**26**	**28**	**48%**

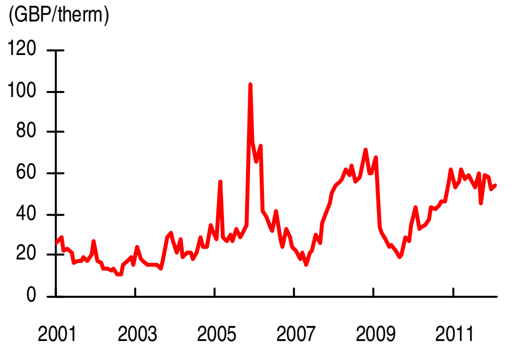
Source: Clarkson, Local Media, HSBC

Proposed North American LNG export projects

Project	Owners	Location	Terminal	Volume	Status
Sabine Pass Liquefaction	Cheniere Energy	Louisiana	Sabine Pass LNG	803	Received conditional DOE approval to export to both FTA and Non-FTA countries. Application is pending with FERC.
Freeport LNG Expansion	ConocoPhillips, others	Texas	Freeport LNG	511	Received conditional DOE approval to export to FTA countries, but approval pending to Non-FTA countries.
Lake Charles Exports	Southern Union	Louisiana	Lake Charles	730	Received conditional DOE approval to export to FTA countries, but approval pending to Non-FTA countries
Carib Energy	Carib Energy	Not Applicable	Not Applicable	12	Received conditional DOE approval to export to FTA countries in South America, Central America, and the Caribbean.
Dominion Cove Point	Dominion Resources	Maryland	Dominion Cove Point LNG	365	Application to export to FTA countries is pending with DOE
Jordan Cove Energy	Fort Chicago and Energy Projects Development	Oregon	Jordan Cove	438	Application to export to FTA countries is pending with DOE
Kitimat LNG	Apache, EOG Resources, Encana	British Columbia, Canada	Kitimat	468	Approved by Canada's National Energy Board

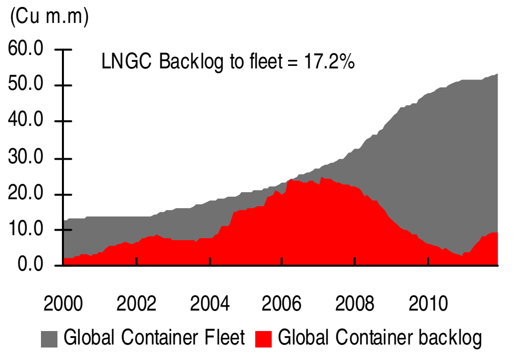
Source: EIA, DOE

UK NBP LNG price trends



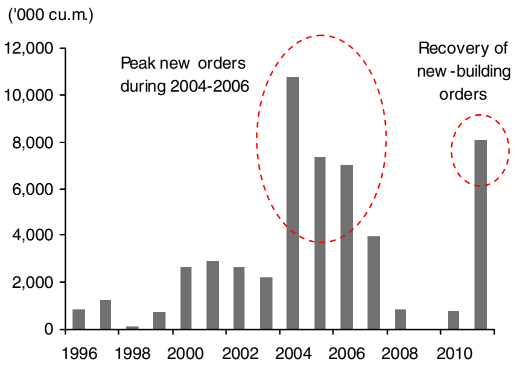
Source: Bloomberg

Global LNGC backlog to fleet



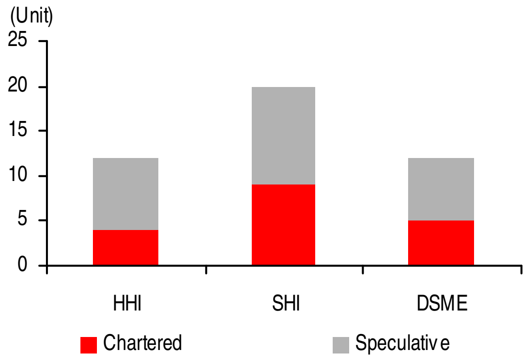
Source: Clarkson

Annual LNGC new order trend



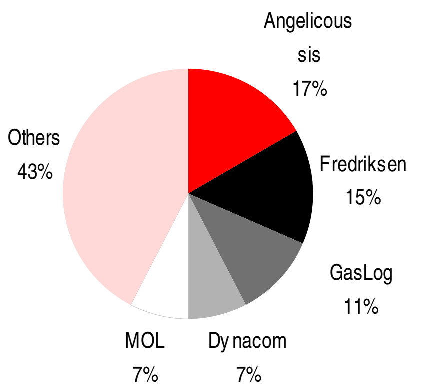
Source: Clarkson, HSBC

Korean Big3 yards LNGC new orders in 2011



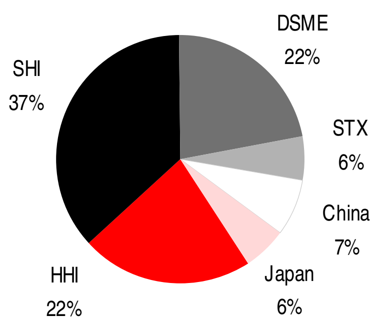
Source: Company data, Clarkson

2011 LNGC new orders breakdown by ship owners



Source: Clarkson

2011 LNGC new orders breakdown by yards



Source: Clarkson

Offshore

With strong oil prices, attractive yard newbuild prices and contract day rates starting, the demand for deepwater drilling units is likely to remain strong. The "fleet renewal" trade across the industry has been very visible, especially in jackups.

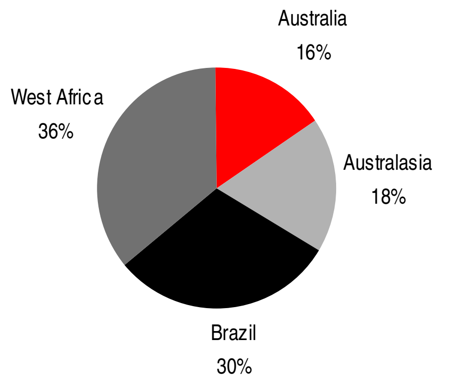
Views from E&P financing – the other indirect effect on OFS markets is the potential impact of tighter credit on E&P financing. In particular, the French banking sector has been an important player in reserve-based lending for E&P activity; clearly, the risk profile for any company looking to use this route has risen (and there have been examples of these banks trying to sell down some of their reserve-based loans – this type of instrument is fairly liquid so is easier to get off the books if needed). But the E&P sector overall is, we think, in a much better position than it was in 2008/09 – companies seem to have learnt not to rely on a continually increasing source of liquidity to meet their commitments, and overall we do not think the "financing" angle will derail growth.

Deepwater and offshore gas

Several of the contracts on the near-term horizon are actually work that were still on the horizon back in 2007/08 – many operators are in "catch-up" mode with deepwater work. But with the important catalysts of rising deepwater rig count and supportive oil prices (most offshore work is "OK" from an investment hurdle viewpoint at USD60-70/bbl; ultra-deepwater at USD70-90/bbl), we expect this theme will start to deliver on the promise that so many contractors (and investors) had expected to see in 2008/09.

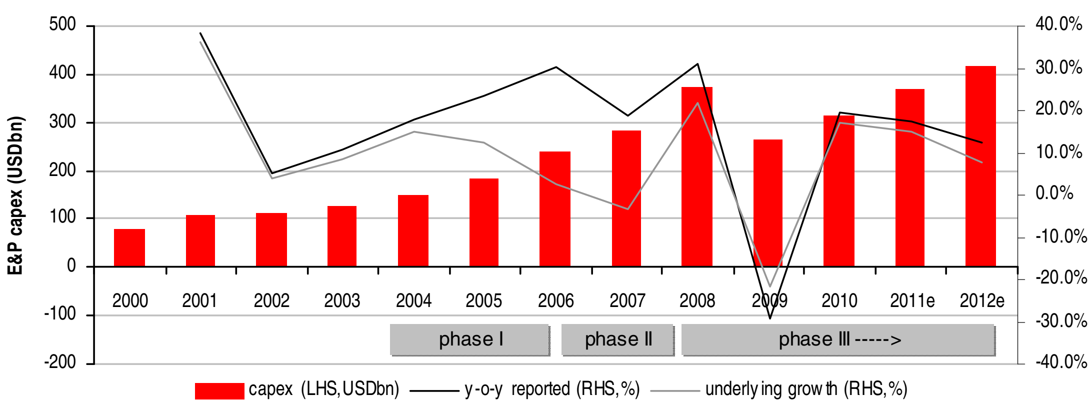
With West Africa, Brazil, a recovering US Gulf, great promise from East Africa and the Australasian region all chasing this work, we expect deepwater production will continue to grow its share of overall production (currently around 7-8%, rising to 10%+ by 2014-15).

USD250bn offshore capex – key regions (2012-16e)



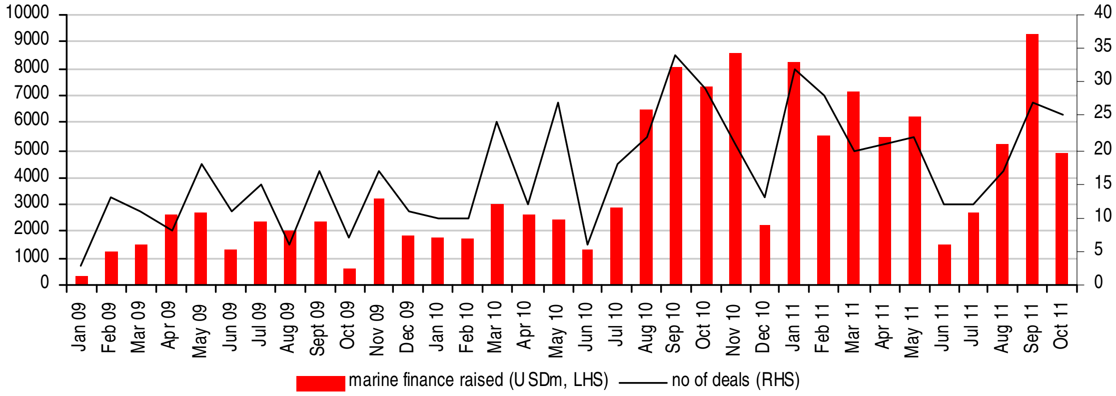
Source: Infield Systems (as at Q3 2011)

A view on E&P upstream capex investment, 2000-12e (plus y-o-y trends for overall activity)



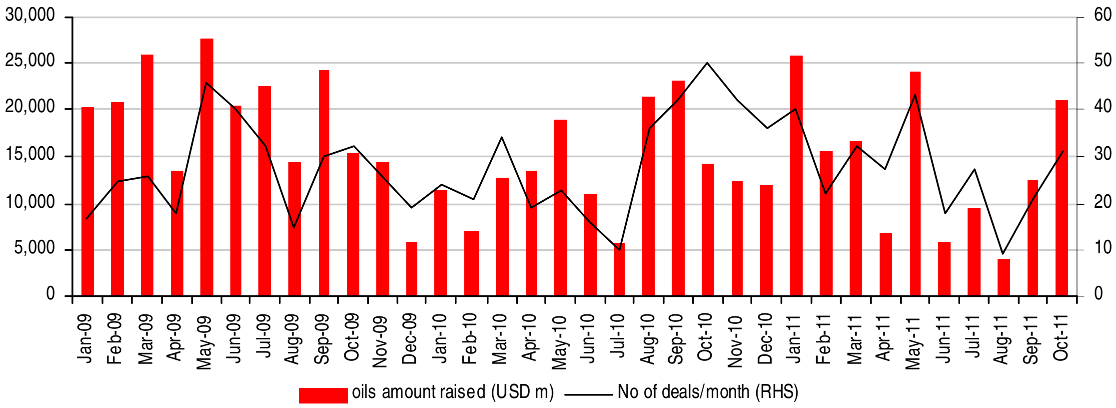
Source: HSBC (survey based on a list of major international oil companies, larger E&Ps, and the mainstream (quoted) emerging market oil companies

Funds raised for marine/offshore/shipping companies, 2009 to 2011-to-date



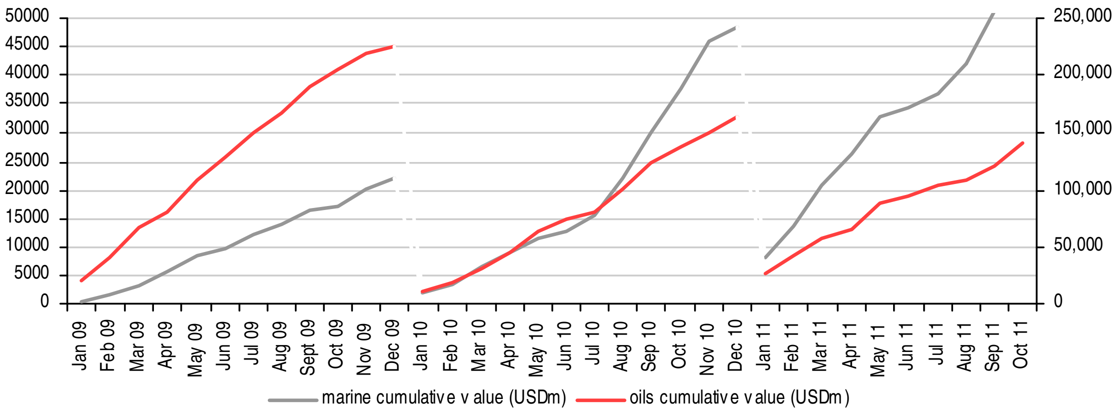
Source: Bloomberg

Funds raised for oil & gas companies, 2009 to 2011-to-date



Source: Bloomberg

Cumulative funds raised for oil & gas and marine/shipping/offshore companies, 2009 to 2011-to-date



Source: Bloomberg

Offshore drilling – industry

Offshore drilling continues to be in recovery mode from the mid-2010 concerns following the Macondo spill in the US Gulf. Some disruption to activity continues in the US Gulf itself, while new regional regulations come into force and work through the system, but these bottlenecks are easing, and elsewhere demand continues to edge up and continues gradually to offset new supply. We note the high uptake of newbuild assets coming to market; financial market fears over the impact of new capacity over 2010-11-12 look to be somewhat overdone.

Offshore drilling fleet – current status

Situation	Drillships	Semis	Jackups
Drilling	47	154	329
Stacked/Standby	5	25	90
(% stacked/standby)	7%	12%	18%
Under Construction	54	15	75
(% under construction)	43%	7%	13%
Yard Repair/Moving/testing	20	29	61
Others (accommodation etc)	0	0	8
TOTAL	126	223	563

Source: ODS Petrodata (as at end Oct 2011)

The key move in 2011 undoubtedly has been the return of newbuild investment over 1Q and part of 2Q – both in high-spec jackups and in deepwater rigs (particularly drillships – USD24bn of floater orders in 2011 so far, of which USD22bn were for drillships). This wave of newbuilds targeted high-end specification vessels, such as 7-shear ram BOPs (blowout preventers), more powerful topdrives & dual derrick designs, larger cranes/drillpipe handling capabilities and larger equipment/fluid handling capacities. Since mid-2011, we have seen a continuation of some new orders for high-end jackups, but somewhat less for the deepwater side; the market is waiting in particular for activity from the long-awaited 21 rig tender from Petrobras (which at the time of publication was "imminent").

In addition to drillers taking a view on improving times ahead, we think the investment wave seen this year also reflects two other important issues:

1. Aggressive pricing from Asian shipyards (eg, all-in price for a newbuild drillship just under USD600m – back to 2005 price levels – plus attractive 20% upfront/80% on completion payment terms) – a window of opportunity that has now at least partially closed; and
2. A strong focus on safety/backup equipment and rig capabilities post the Macondo spill; this has driven a wave of refurbishment/ modification work (to the extent that some bottlenecks are becoming apparent with certain equipment suppliers, such as BOPs).

Offshore drilling – planned deliveries of newbuild rigs

Delivery year	Drillship	Jackup	Semisubmersible	Total
2011- Delivered	12	16	12	40
2011-Under Cons	9	2	3	14
2011-Total	21	18	15	54
2012	6	22	9	37
2013	24	37	2	63
2014	9	14	3	26
2015	2			2
After 2015	5			5
Total	76	93	32	201

Source: ODS Petrodata (as at November 2011)

Overall, we expect dayrates for older rigs (of all categories – jackups and floaters) will struggle to improve over the next few years (some local pockets of improvement are possible, eg. certain older jackups in India & parts of SE Asia). This has important implications for investors looking to play the typical cyclical "bounce" for lower-end (cheaper) assets; we think this time the "bounce" is likely to be much less pronounced.

High-end and harsh-environment jackups should see dayrate improvements (we would note strong tendering activity from the North Sea, in particular), but in the near term this could be capped to some extent by oversupply in other (older) categories, and midwater floaters are unlikely to see upside until most of the newbuild deepwater supply

(including rigs displaced from the GoM – six so far) has been put to work (and even then, most of these midwater floaters are older rigs).

Deepwater (specifically ultra-deepwater) markets are still absorbing new supply but have already managed to post improvements in contracted rates (with some contracts already rolling over or being set north of USD500/day). We think further improvements in deepwater dayrates could well be visible in contracts in 2012 – as ever, potential demand from Brazil remains the largest "moving part" that could accelerate this picture.

We continue to expect Petrobras' own plans to build a Brazilian-operated deepwater fleet in Brazil will fall short of delivering rigs on the timescales needed to handle presalt development drilling, with the likely result that Brazil will continue to offer substantial work for the international drilling contractors.

Petrobras – planned needs for offshore vessels, current-2020

Resources	End 2010	By 2013	By 2015	By 2020
Deepwater rigs (2,000m + depth)	15	39	37	65
Supply/offshore vessels	287	423	479	568
Production platforms/FPSOs	44	54	61	94
Other platforms (TLWP, etc)	78	80	81	83

Source: Petrobras (from the 2011-15 investment plan)

The outlook for orders across offshore categories is, we think, quite positive over the next few years, but the mix is likely to be different:

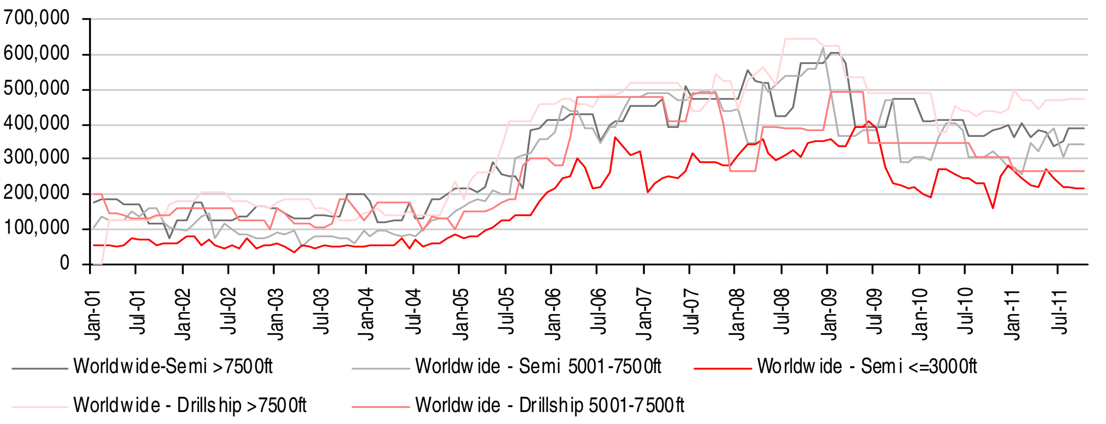
- **Jackup rigs** – we expect the "fleet renewal" trade to remain on and expect to see a significant number of orders as the drilling industry upgrades its existing (old) fleet. This is likely to prove good news for the specialised Singapore yards, some Chinese yards and also Middle Eastern facilities like Lamprell (playing their cost advantage).
- **Floater rigs** – after the wave of drillships in 2010/11, we expect more of a balance between orders for semi-submersibles and drillships in 2012/13. Brazil remains the single largest moving part in this, with its ongoing tender for 21 new deepwater units to be built in Brazil itself (most are drillships). The winners from this are likely to be the mainstream Korean yards (for business with international drilling contractors in particular), but we note that the single largest tender for newbuilds is focused on Brazilian construction.
- **FPSOs** – we expect conversion to pick up over the next few years, which raises the question as to whether there is enough yard space in Singapore to handle this specialised work. We expect more early-stage conversion work (not modules or integration) going to Chinese and other yards where there is capacity to ease the bottleneck. Newbuild work will also likely see decent activity, we think, which is likely to fall to the Korean yards (as is further work around floating LNG – FLNG).

Newbuild activity in 2011 – USD24bn of orders of floater rigs placed year to date

Order date	Rig Name	Rig contractor	Shipyard	Cost (USDm)
Drillships				
Jan-11	Ocean BlackHawk	Diamond Offshore	Hyundai Heavy	590
	Noble Drsh Tbn5	Noble	Hyundai Heavy	605
	Noble Drsh Tbn6	Noble	Hyundai Heavy	605
	Transocean Drsh Tbn1	Transocean	Daewoo	600
	Transocean Drsh Tbn2	Transocean	Daewoo	600
	Atwood Advantage	Atwood	Daewoo	600
Feb-11	Ocean BlackHornet	Diamond Offshore	Hyundai Heavy	590
	Sete Brasil Drsh Tbn1	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn2	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn3	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn4	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn5	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn6	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
	Sete Brasil Drsh Tbn7	Sete Brasil	Estaleiro Atlantico Sul (EAS)	662
Mar-11	Noble Drsh Tbn7	Noble	Hyundai Heavy	615
	Pacific Khamsin	Pacific Drilling	Samsung Heavy	550
	Pacific Sharav	Pacific Drilling	Samsung Heavy	550
Apr-11	Maersk Drsh Tbn1	Maersk Drilling	Samsung Heavy	650
	Maersk Drsh Tbn2	Maersk Drilling	Samsung Heavy	650
	West Tellus	Seadrill	Samsung Heavy	600
	Fred Olsen Drsh Tbn1	Dolphin	Hyundai Heavy	615
	OCR Drillship Tbn1	Ocean Rig	Samsung Heavy	638
	OCR Drillship Tbn2	Ocean Rig	Samsung Heavy	638
May-11	Tungsten Explorer	Vantage Drilling	Daewoo	590
	Ocean BlackRhino	Diamond Offshore	Hyundai Heavy	610
Jun-11	Rowan Drsh Tbn1	Rowan	Hyundai Heavy	740
	Rowan Drsh Tbn2	Rowan	Hyundai Heavy	738
	OCR Drillship Tbn3	Ocean Rig	Samsung Heavy	638
Jul-11	Maersk Drsh Tbn3	Maersk Drilling	Samsung Heavy	650
	Maersk Drsh Tbn4	Maersk Drilling	Samsung Heavy	650
Sep-11	Noble Drsh Tbn8	Noble	Hyundai Heavy	630
	Opus Drsh Tbn1	Opus Offshore	Shanghai Shipyard	400
	Opus Drsh Tbn2	Opus Offshore	Shanghai Shipyard	400
Oct-11	Atwood Achiever	Atwood	Daewoo	600
Nov-11	Rowan Drsh Tbn3	Rowan	Hyundai Heavy	650
			Total	**21,629**
Semi-submersibles				
May-11	Sevan UDW3	Sevan Drilling	COSCO Nantong	526
	Sevan UDW4	Sevan Drilling	COSCO Nantong	526
Jul-11	Songa Semi Tbn2	Songa Offshore	Daewoo	565
	Songa Semi Tbn3	Songa Offshore	Daewoo	565
			Total	**2,182**

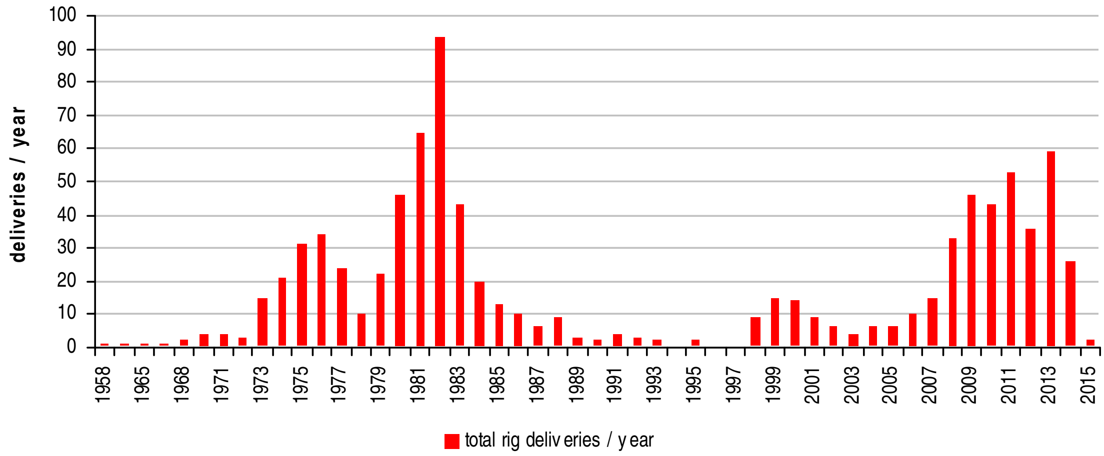
Source: IHS ODS Petrodata

Typical dayrate trends for floater rigs, 2001-present (dayrates in USD/day)



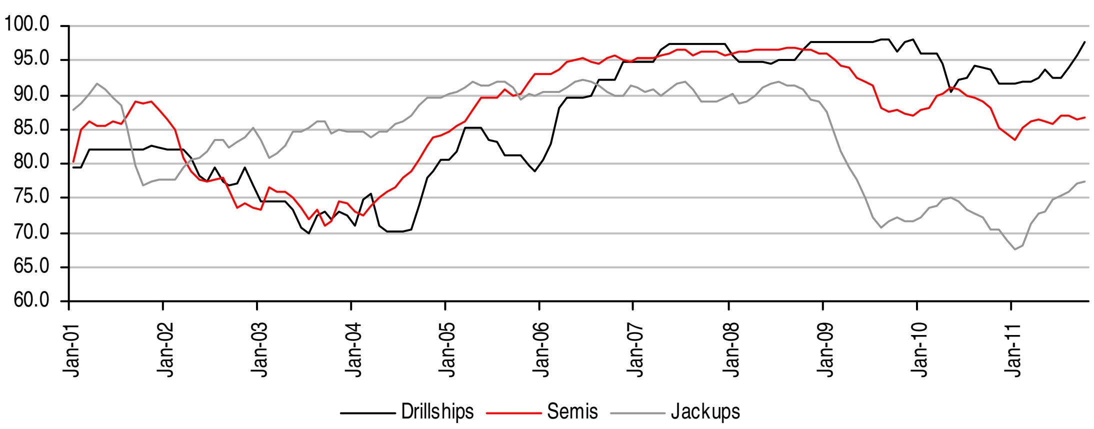
Source: ODS Petrodata

Offshore drilling – pattern of total rig deliveries per year from the 1960s to present (includes jackups, drillships and semi-subs)



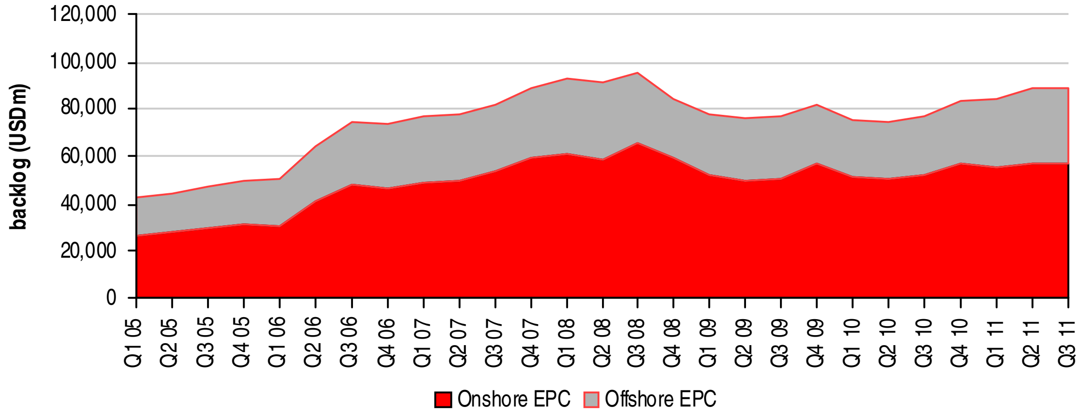
Source: ODS Petrodata

Offshore drilling – overall rig category utilisation trends, 2001-present (utilisation in %)



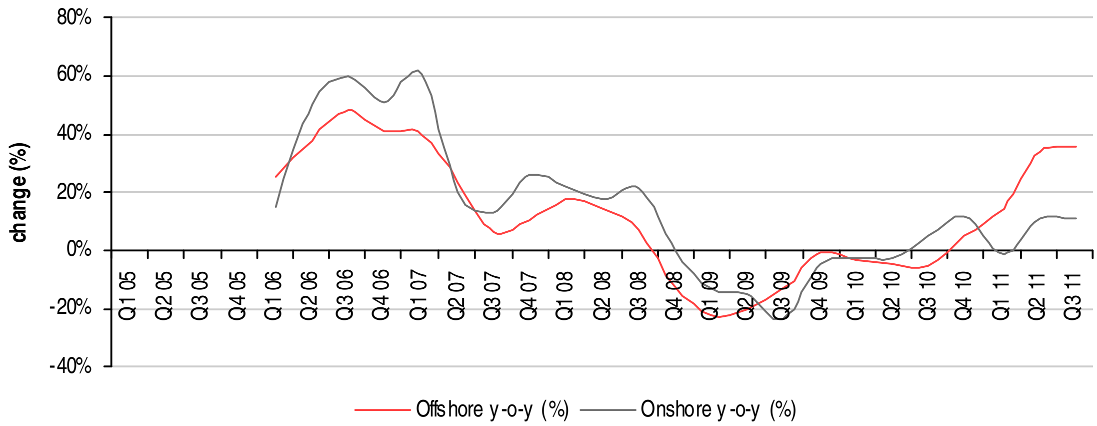
Source: ODS Petrodata

Evolution of onshore and offshore E&C backlogs, 2005-present



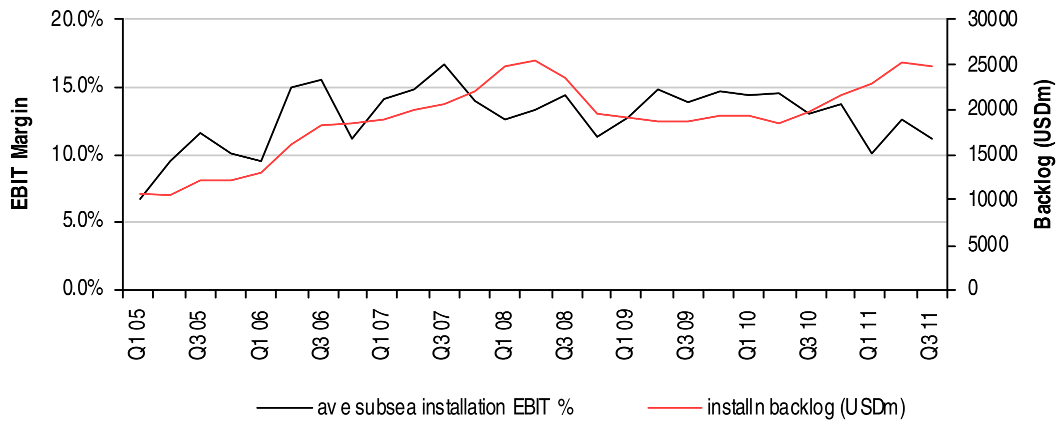
Source: Company data

Y-o-Y growth in onshore and offshore E&C backlogs, 2005-present



Source: Company data

Offshore installation – EBIT margin trends, 2005-present



Source: Company data

Medium-term outlook for E&C activity, USD562bn total investment potential over 2012-14 – main regions, key projects, approximate size of market opportunities

USDbn	Europe & Eurasia	Asia	Africa	Lat Am	North America	Middle East	Australia
Gas monetisation	**17**	**11**	**46**	**3**	**57**	**5**	**81**
Potential projects TOTAL USD220bn	• Snohvit LNG Train 2	• Malaysia LNG Train 9 • Tangguh LNG Train 3	• Anadarko Mozambique LNG • BG Tanzania LNG • NLNG Seven Plus • SEGAS TR 2 NB: expect Mozambique LNG FEED award in Q2 2012, EPC in Q4 2013		• Kitimat LNG Tr I&II • BG Canada LNG Tr I & II • BG Trunkline LA LNG • Cameron LNG • Freeport LNG • Sasol/Talisman Canadian GTL • Shell US GTL NB: expect Kitimat LNG Train 1 award Q2 2012, Train 2 Q2 2013		• Inpex Ichthys LNG • Arrow Energy LNG Tr I&II • Arrow Energy LNG Tr III&IV • Browse LNG • Gorgon Tr 4 • Pluto LNG Tr 2&3 NB: expect Icthys LNG EPC award by end 2011, Browse LNG RPC award in H2 2012
Oil & Gas	**24**	**18**	**33**	**22**	**18**	**19**	**10**
Potential projects TOTAL USD144bn	• Shah Deniz Phase 2 • TCO Future Growth Project • Karachaganak Phase 3 • Pearls Project • HOD Redevelopment • Rosebank NB: Shah Deniz Ph 2 construction management award in Q1 2012, engineering services in Q1 2013	• Chevron Vietnam Block B • Chevron Gendalo-Gehem • Ubon Development	• Lucapa FPSO, Angola • Mafumeira Sul (SMAD) • Tweneboa 1&2 Development • Quiluma Wellhead Platform • Chissonga FPSO Topsides • Reggane Nord Development NB: EPC award for Lucapa FPSO expected in Q4 2011	• Peregrino II FPSO • Petrobras 8 FPSO • Petrobras P14/P17 rig upgrades	• Kaskida, GoM • Hadrian, GoM • White Rose Extension, Canada • Hess Pony TLP	• Rumaila Field • Shell Majnoon Full Field • Umm Lulu • SARB Field Development • Dorra Oil & Gas Field • ZADCO UZ-750K Project NB: award expected in Q2 2012	• Browse Upstream development • Ichthys FPSO topsides • Scarborough offshore • Hess Equus
Downstream	**31**	**13**	**33**	**30**	**33**	**58**	**0**
Potential projects TOTAL USD198bn	• TOTAL Antwerp Refining – ROSE • Ustyurt Gas Chemical complex • Pavlodar Refinery upgrade • Rosneft Primorsk Refinery • Gazprom Olefins	• Fertilizers • Refinery modernization	• Sonangol Refinery Phase I • PetroSA Project Mthombo • Natref Clean Fuels, S Africa • Sasol Gasoline hydrogenation NB: Sonaref EPCm award expected in 2012	• Tula Refinery, Mexico Asia pacific • Isthmus – Advance bio-ethanol project • Cadereyta Refinery Diesel HDS, Mexico • Ecopetrol PCIP Liquid, Ethylene Cracker • Petromonagas	• Corunna Cracker Revamp • INEOS Olefins • Shell Grassroots Ethylene • Gulf Coast ethylene • Baytown Lubes Expansion • Toledo Repositioning Proj • PPG Chloralkali expansion • PCS Phosphate Ammonia • KiOR's Newton Phase 2	• Shell/QP Petrochemicals, Qatar • Sadara EO Derivatives • Sadara CPMC Amendment • Sadara HP-LDPE • PetroRabigh II Project • Fujairah Refinery, UAE • KNPC Clean Fuels 2020 • KNPC New/4th Refinery • Millenium Inorganic Chemicals (TiO2), Saudi • United Cracker NB: Sadara FEED near completion, PMC ramping up, Jazan FEED underway	
TOTAL USD562bn	**72**	**42**	**112**	**55**	**108**	**82**	**91**

Source: KBR (from November 2011 Analyst Presentation)

Floating production/FPSO – industry

The FPSO industry slowed down in late 2010 after a brief flurry of growth, but despite what seemed to be good new contract potential on the horizon earlier this year, 2011 has somewhat underperformed market expectations. Brazil has been busy (Petrobras/OGX), but the real growth for the industry remains on the horizon. However, we think this should come; in particular, recent LOIs point towards positive newsflow in the next few quarters (from Brazil, SE Asia, West Africa and the North Sea). Part of this is because of a pick-up in offshore activity overall, but part is also a reflection that the industry is still working through a backlog of delayed projects from the last cycle.

But for an industry that needs only a few major contracts a year to keep it going, we think this mix looks interesting. The demand outlook over the next few years is roughly 10-15 FPSO contracts per year (covering both small and larger vessels) with the regional mix being the usual blend of Asia, West Africa, Brazil and also the North Sea. As with most offshore markets, the peak activity period in the medium term is around the 2014/15 period – the market is likely to be dominated by LatAm and West Africa (we think around 30% of the market each), followed by Australasia and South East Asia (both around 15%), and the remainder mostly the North Sea. The mix of projects on the horizon is split roughly 50% lease, 20% redeployment (tends to be more for shorter contracts, five years or less) and 30% construction. There has also been scrapping of older vessels – 2010 saw nine vessels coming to the end of their contracts (all are 25 years old or more, some from the 1970s), and we see further scrapping of old vessels (have seen this from Fred Olsen, SBM, Modec and Oceaneering).

Elsewhere, the gradual advance of floating LNG – FLNG – continues, but this new market is, we think, probably still some way from a real wave of contract awards (although for those involved – Technip, Samsung, SBM Offshore, working on Shell's Prelude – the revenues from this work ramp up significantly in 2012). The first and most watched is of course the ongoing Prelude project (with the potential for FEED work for a second vessel to come in 2012); we think there is also potential for more projects to come in SE Asia, as well as Australia. But there are clear uncertainties – we note Petrobras this year delayed its own intentions for FLNG (as a solution for gas handling in the Santos Basin), and Woodside might look at piped gas to onshore LNG for its Sunrise project (rather than FLNG).

Another view on future FPSO prospects – new projects 2010-14

Region	In service	Prospects 2010-14	Comments
North Sea	22	13	Baseline business for many operators, still reasonable growth, prospects for re-deployments and replacements (eg, BWO "Carmen" vessel)
Mediterranean	4	5	
China	14	4	
Asia	35	28	FPSO-heavy market, although many are smaller units, main deepwater potential is in medium term, also floating LNG on the horizon (needs high pressure/large diameter SURF), looking for Shell Prelude FLNG final investment decision in early 2011
West Africa	34	30	Major FPSO market, especially for large "build & own" vessels rather than lease, driven by 'supply & install' contracting, high local content, also seeing growth from newer regions, eg, Ghana as well as signs of activity recovery elsewhere in West Africa
Brazil	29	36	Substantial FPSO experience, already a key region, set to become even more important especially for large (120-150kbpd+) vessels, boosted by presalt and other basins (eg, OGX), also demand from international oil companies increasing; local content/logistics support is key and potentially is a medium-term bottleneck given local logistics & shipyards
Americas	4	4	Smaller market for FPSOs, disconnectable technology likely key; some on Pemex side of the Gulf, some project delay risks post Macondo blowout
Total vessels	**142**	**120**	

Source: Wellstream, IMA (International Maritime Associates)

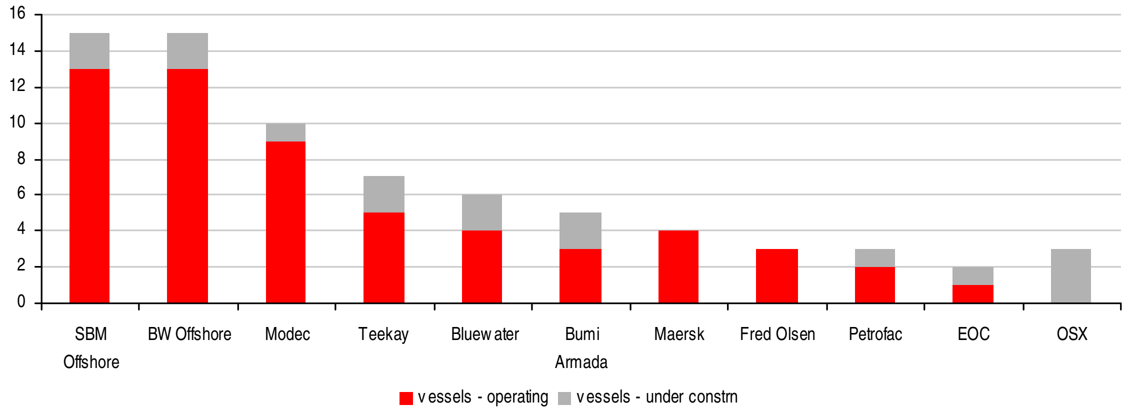
HSBC

Outlook for key FPSO and related projects on the near and medium-term horizon (the combined views of SBM Offshore and Modec)

type	project	company
FPSO (lease)	Peregrino II	Statoil
FLNG (FEED/EPC)	Tupi	Petrobras
FPSO (lease)	Siri	Petrobras
FPSO (extension)	Brasil	Petrobras
FPSO (extension)	Marlim Sul	Petrobras
FSO (lease)	Santos Basin	BG Group
FPSO	Western Isles, UK North Sea	Dana
FPSO	Ayatzil-Tekel, Mexico	Pemex
FPSO	Fram, UK North Sea	Shell
FPU	Kudu, Namibia	Tullow
FPSO (lease)	Chissonga, Angola block 16	Maersk
FPSO (EPC)	Angola Block 31	BP
FPSO (EPC)	Angola Block 31	BP
FPSO (extension)	Kuito	Chevron
FPSO (EPC)	Angola Block 32	Total
FPSO (EPC)	Angola Block 32	Total
FPSO (lease)	Angola Block 15	Eni
TLP (EPC)	Moho Nord, Angola	Total
FPU (EPC)	Moho Nord	Total
FPSO	TEN, Ghana	Tullow
FLNG (lease)	Timor Sea	PTTEP
FLNG (EPC)	Indonesia, Masela	Inpex
FPSO	Deepwater Brunei	Shell
gas FPU (EPC)	Shtokman, Russia	Gazprom
FPSO (lease)	Fram	Shell
FPSO (lease)	Ghana, Jubilee 2	Tullow
FPSO	Madura, Indonesia	CNOOC
FPSO	Lucapa, Angola Block 14	Chevron
FPSO	Teak, Ghana	Kosmos
FPSO	Vietnam, Block 102/106	PC
TLP (EPC)	Malaysia, Malaikai	Shell
LNG development	Australia, Browse	Woodside
FPSO	Australia, Lady Nora	Woodside
FSO (lease)	Mexico, Ta'Kuntah life extension	Pemex
FPSO	Brazil, Cernambi Sul	Petrobras
FPSO	Brazil, Guanambi	Petrobras
CALM buoys, Turrets	Santos/Campos Basins/Brazil, Egina/Angola, Shtokman/Russia	<various>

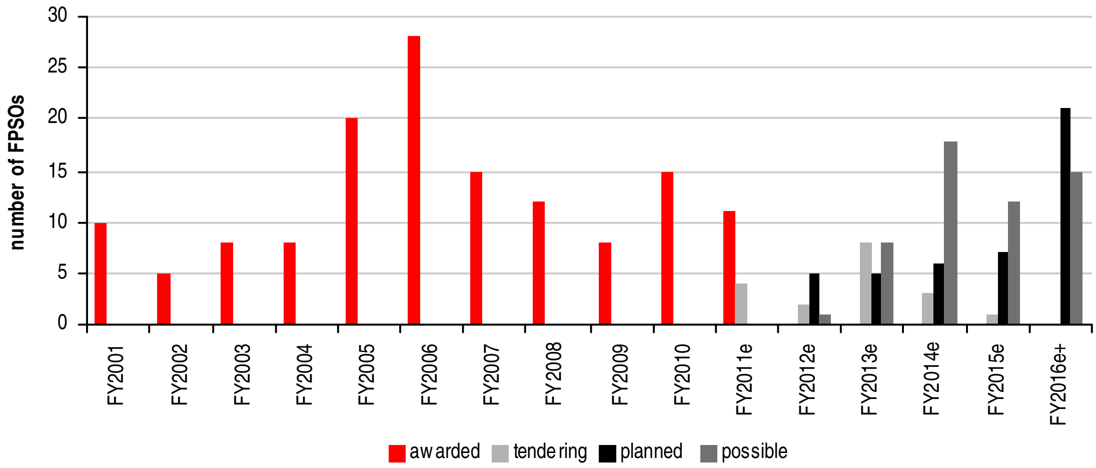
Source: SBM Offshore, Modec

Leased FPSOs – major players listed by vessels producing and under construction



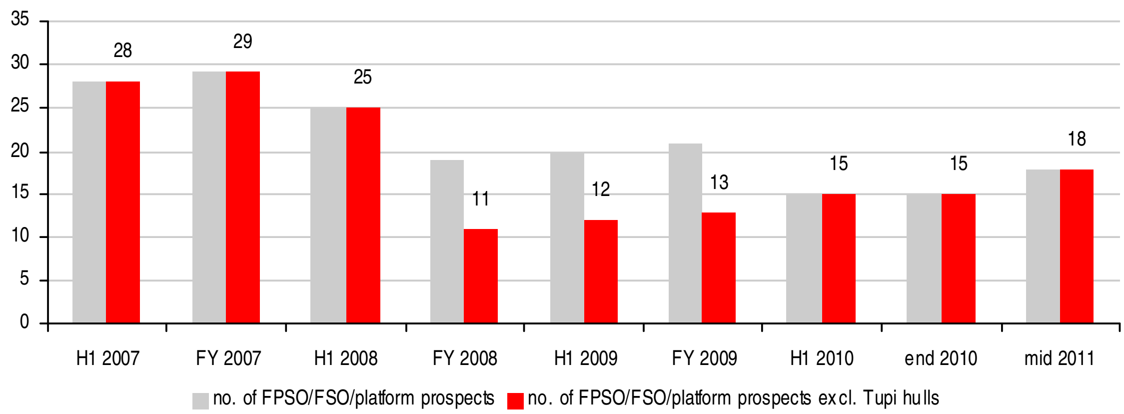
Source: SBM Offshore

Historical project awards and outlook for new contracts, 2001-16e+



Source: Company data, HSBC estimates from 2011e onwards

Signs that the "new prospect" cycle for FPSOs has bottomed – enquiries on the up (from SBM Offshore)



Source: SBM Offshore

Company section

HSBC

Hyundai Heavy (009540)

- Recent correction makes valuations relatively undemanding but we do not see any positives for the stock yet
- Negative fundamentals outweigh the technical perspective; low vessel pricing, new orders and weaker non-shipbuilding earnings
- Maintain Neutral (add V flag); SOTP-based TP of KRW320,000 (KRW350,000 previously)

We remain Neutral (add V flag) on HHI. Despite its weak share performance in 2H11, we do not see positive stock drivers. We cut our SOTP-based target price to KRW320,000 from KRW350,000 as we expect earnings to decline this year and new orders are unlikely to improve in 2012.

As its non-shipbuilding division is unlikely to show any signs of recovery, we think the stock will become more cyclical in 2012 – it was previously seen as a growth story. Thus, we need to see better earnings growth drivers before we change our investment stance.

Lacklustre non-shipbuilding divisions

The stock has become more cyclical due to weaker-than-expected earnings from non-shipbuilding divisions. Unlike pure shipbuilders which are highly linked to new orders, HHI's performance has a higher correlation with its earnings. The company recently announced an aggressive 2012 new order target of USD30.6bn despite the sluggish non-shipbuilding business outlook.

Shipbuilding: Despite strong orders in 1H11, vessel prices have not moved up, reflecting excess capacity. With new order momentum slowing down, we may see further downside risks to vessel prices and profitability of new orders in 2012. According to Clarkson, the new-build price dropped 2.4% in 2H11 due to weaker demand and tougher financing conditions. Thus, it is likely to remain a buyer's market, leading to weaker new-build pricing. We do not expect any improvement in the major sector drivers, including new orders and vessel prices.

Industrial plant: HHI achieved only 27% of its new order target up to November 2011, due to delayed projects. As no new significant orders were announced in December, the division is likely to miss the annual target of USD5m.

Electro-electric: We believe weak margins will continue as HHI cut prices to secure more orders due to higher competition and weaker demand, especially on circuit breakers. The transformer industry shows signs of slight recovery.

Green energy: The utilisation rate in solar cell/module plants is below 50%, leading to weaker earnings in 2012. And the company has confirmed that solar cell capacity expansion to 1GW (from 600MW now) is officially put on hold.

Construction equipment: Volume and margin contraction in inevitable in 2012e due to a potential

HHI: Earnings forecast revisions (changes to IFRS consolidated basis from K-GAAP parent basis)

	New		Old		Chg		Consensus	
(KRWbn)	2012e	2013e	2012e	2013e	2012e	2013e	2012e	2013e
Sales	52,890	54,591	24,702	25,998	114.1%	110.0%	53,355	56,162
Operating Profit	3,638	4,235	3,075	3,078	18.3%	37.6%	4,087	4,399
OPM	6.9%	7.8%	12.4%	11.8%			7.7%	7.8%
Net Profit	2,402	2,950	3,110	3,108	-22.8%	-5.1%	3,096	3,365
NPM	4.5%	5.4%	12.6%	12.0%			5.8%	6.0%

Source: Bloomberg, HSBC estimates.

30% industry decline in 1Q12e. Besides, the Ministry of Railway in China is reducing its infrastructure spending this year to RMB400bn, 20% below market consensus, which should have a negative impact for 2012.

Oil refinery: HSBC's Asia oil and gas team estimates the Asia benchmark refining margin will fall to mid-cycle level in 2012-13 on the back of regional refiners coming back online after maintenance and accelerated global refining capacity additions. We expect the weakness to be most apparent in the light products like gasoline and naphtha, while the middle distillates such as diesel and jet kerosene should remain resistant due to strong demand from emerging countries. Refinery earnings should also get support from paraxylene (PX), where huge expansion of downstream capacity expansion is planned.

Cyclically not attractive but trading opportunities exist

While we believe HHI is less attractive than a year ago, we think there are trading opportunities

HHI: Earnings forecast revisions (changes to IFRS consolidated basis from K-GAAP parent basis)

	New		Old		Chg	
(KRWbn)	2012e	2013e	2012e	2013e	2012e	2013e
Sales	**52,890**	**54,591**	**24,702**	**25,998**	**114.1%**	**110.0%**
Shipbuilding	18,667	18,796	8,162	8,471	128.7%	121.9%
Offshore	4,003	4,404	4,121	4,327	-2.9%	1.8%
Engines/Machinery	2,291	2,520	3,215	3,375	-28.7%	-25.3%
Electro-Systems	3,307	3,638	3,307	3,638	0.0%	0.0%
Industrial Plant	2,902	3,047	3,068	3,222	-5.4%	-5.4%
Construction Equipment	4,730	4,938	2,682	2,816	76.4%	75.3%
Oil Refinery	16,389	16,649	0	0	n.a.	n.a.
Finance	600	600	0	0	n.a.	n.a.
Others	0	0	148	149	n.a.	n.a.
Operating Profit	**3,638**	**4,235**	**3,075**	**3,078**	**18.3%**	**37.6%**
Shipbuilding	1,324	1,715	1,008	1,022	31.4%	67.8%
Offshore	480	440	453	433	6.0%	1.8%
Engines/Machinery	283	384	707	709	-60.0%	-45.8%
Electro-Systems	198	255	298	364	-33.3%	-30.0%
Industrial Plant	290	305	368	354	-21.2%	-14.0%
Construction Equipment	521	527	241	197	115.6%	167.5%
Oil Refinery	469	537	0	0	n.a.	n.a.
Finance	72	72	0	0	n.a.	n.a.
OP margin	**6.9%**	**7.8%**	**12.4%**	**11.8%**	**-5.6%**	**-4.1%**
Shipbuilding	7.1%	9.1%	12.3%	12.1%	-5.3%	-2.9%
Offshore	12.0%	10.0%	11.0%	10.0%	1.0%	0.0%
Engines/Machinery	12.4%	15.2%	22.0%	21.0%	-9.6%	-5.8%
Electro-Systems	6.0%	7.0%	9.0%	10.0%	-3.0%	-3.0%
Industrial Plant	10.0%	10.0%	12.0%	11.0%	-2.0%	-1.0%
Construction Equipment	11.0%	10.7%	9.0%	7.0%	2.0%	3.7%
Oil Refinery	2.9%	3.2%	n.a.	n.a.	n.a.	n.a.
Finance	12.0%	12.0%	n.a.	n.a.	n.a.	n.a.

Source: HSBC estimates. *Note: Electro-electric division includes green energy business

depending on new orders, seasonality of freight rate, new vessel price, macro issues and better earnings from non-shipbuilding business. Besides, if the company decides to divest its affiliates (i.e. Hyundai Oilbank) either through IPO or private sales, this could be a positive catalyst for the stock. On the other hand, the stock could be negatively affected if HHI engages in non-heavy related M&A.

Switch from K-GAAP to K-IFRS

We have revisited our estimates due to the company's switch from K-GAAP to K-IFRS. We now forecast sales numbers on a K-IFRS consolidated basis, which includes its major affiliates such as Hyundai Samho and Hyundai Oilbank.

We have raised sales number by 114% for 2012e and 110% for 2013e to reflect its affiliates' sales numbers. Its operating profit also includes earnings of the affiliates, so we have raised our operating profit forecast by 18% for 2012 and 38% for 2013. However, we have cut net profit by 23% for 2012 and 5% for 2013, as the previous net income under K-GAAP also included most of the major affiliate contribution via equity income, along with a minority interest adjustment.

Valuation and risks

We maintain our Neutral (V) rating on Hyundai Heavy. With its more diversified business portfolio, HHI has less exposure to pure shipbuilding and downside risk is relatively limited compared to pure plays, in our view.

For HHI, we change our assumptions under our sum-of-the-parts valuation and lower our target price to KRW320,000 from KRW350,000. We believe SOTP is an appropriate valuation methodology given HHI's divisional structure, broad mix of activities and various investment assets. This does not apply to pure play such as SHI. Under our new HHI SOTP valuation, we include HHI's investment assets, apply 5.0x EV/EBITDA multiples to each business division and include its treasury shares to calculate HHI's NAV.

Under our research model, for Korea stocks with a volatility indicator the Neutral band is 10ppt above and below the hurdle rate of 10.5% This translates into a Neutral band of 0.5-20.5%. As our target price implies a potential return of 12.9% (including dividend yield), within the Neutral band, we rate HHI N(V). We add the volatility flag in recognition of the stock's historical volatility having increased. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks to our view: 1) continued oversupply, leading to a further delay in new order recovery; 2) slower-than-expected macro recovery; 3) a sharp rise in the won; 4) a sharp rise in steel plate prices; and 5) intensifying competition from Chinese yards.

Key upside risks to our view would come from the announced IPO of Hyundai Oilbank, a 90%-owned subsidiary of HHI.

Hyundai Heavy Industries: SOTP valuation summary

Operating asset value (KRW bn)					**23,387**
Division	2012 EBITDA	EV/EBITDA	EV	Discount	
Shipbuilding	1,685	5.0	8,424	0.0%	
Offshore	535	5.0	2,677	0.0%	
Engines/Machinery	395	5.0	1,974	0.0%	
Electro-Systems	353	5.0	1,766	0.0%	
Industrial Plant	299	5.0	1,497	0.0%	
Construction Equipment	561	5.0	2,804	0.0%	
Oil Refinery	716	5.0	3,580	0.0%	
Others	133	5.0	664	0.0%	
Non-operating asset value (KRW bn)					**3,360**
			NAV	Discount	
LT Available for sales			3,667	30.0%	
ST Available for sales			92	30.0%	
Subsidiaries and JV			1,042	30.0%	
2012e net debt (KRWbn)					**7,083**
Equity value (KRWbn)					**19,664**
Shares outstanding (m)					61.3
Target price (KRW)					**320,000**

Source: Bloomberg, HSBC estimates.

Financials & valuation: Hyundai Heavy Industries

Neutral (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (KRWb)				
Revenue	23,261	52,263	52,890	54,591
EBITDA	2,310	5,421	4,728	5,334
Depreciation & amortisation	-630	-1,039	-1,090	-1,099
Operating profit/EBIT	1,680	4,382	3,638	4,235
Net interest	-76	-242	-203	-95
PBT	2,776	4,130	3,514	4,317
HSBC PBT	2,776	4,130	3,514	4,317
Taxation	-521	-1,024	-850	-1,045
Net profit	2,254	2,791	2,402	2,950
HSBC net profit	2,254	3,106	2,664	3,272
Cash flow summary (KRWb)				
Cash flow from operations	3,037	-1,348	2,863	3,316
Capex	-565	-2,000	-2,000	-2,000
Cash flow from investment	-383	-1,676	-2,044	-2,058
Dividends	-97	-61	-47	-39
Change in net debt	-2,020	8,192	-1,737	-2,561
FCF equity	1,617	-2,567	1,510	2,265
Balance sheet summary (KRWb)				
Intangible fixed assets	1,216	1,971	2,015	2,056
Tangible fixed assets	6,098	15,536	15,664	15,923
Current assets	4,584	25,869	27,642	29,330
Cash & others	2,256	3,130	4,517	5,717
Total assets	18,625	50,994	53,089	55,375
Operating liabilities	6,080	17,008	16,753	17,068
Gross debt	2,884	11,950	11,599	10,238
Net debt	628	8,820	7,083	4,521
Shareholders funds	9,661	16,631	18,974	21,876
Invested capital	3,562	23,238	24,051	24,524

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	26.3	124.7	1.2	3.2
EBITDA	26.4	134.7	-12.8	12.8
Operating profit	46.8	160.8	-17.0	16.4
PBT	63.3	48.8	-14.9	22.8
HSBC EPS	55.4	23.8	-13.9	22.8
Ratios (%)				
Revenue/IC (x)	5.7	3.9	2.2	2.2
ROIC	37.8	25.2	12.0	13.5
ROE	26.5	23.6	15.0	16.0
ROA	11.7	10.0	5.8	6.6
EBITDA margin	9.9	10.4	8.9	9.8
Operating profit margin	7.2	8.4	6.9	7.8
EBITDA/net interest (x)	30.5	22.4	23.3	55.9
Net debt/equity	6.5	53.0	37.3	20.7
Net debt/EBITDA (x)	0.3	1.6	1.5	0.8
CF from operations/net debt	483.8		40.4	73.3
Per share data (KRW)				
EPS Rep (fully diluted)	36272.97	44859.66	38430.71	47297.54
HSBC EPS (fully diluted)	36775.06	45534.36	39188.87	48140.41
DPS	1000.00	1000.00	771.79	641.20
Book value	157605.37	271326.98	309584.39	356929.69

Valuation data

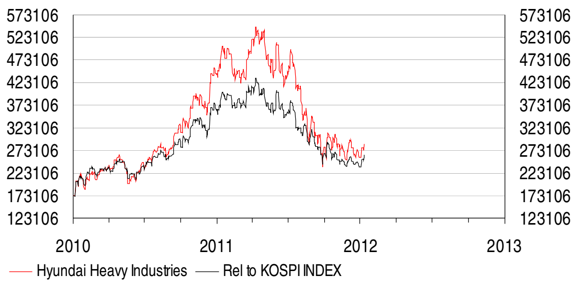
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.0	0.5	0.4	0.4
EV/EBITDA	9.7	4.7	5.0	3.9
EV/IC	6.3	1.1	1.0	0.9
PE*	7.8	6.3	7.3	6.0
P/Book value	1.8	1.1	0.9	0.8
FCF yield (%)	7.4	-15.3	9.1	13.8
Dividend yield (%)	0.3	0.3	0.3	0.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price	(KRW)288000.00	Target price	(KRW)320000.00
Reuters (Equity)	009540.KS	Bloomberg (Equity)	009540 KS
Market cap (USDm)	18,970	Market cap (KRWb)	21,888
Free float (%)	64	Enterprise value (KRWb)	25626
Country	Korea	Sector	MACHINERY
Analyst	Paul Choi	Contact	+822 3706 8758

Price relative



Source: HSBC

Note: price at close of 11 Jan 2012

HSBC

Samsung Heavy (010140)

- Strong offshore and LNGC demand to continue in 2012; SHI should be the biggest beneficiary from LNG FPSO
- Limited downside due to the large number of secured options for new building orders and lower risk exposure to payment delay
- Upgrade to OW(V) from N; PB-based TP of KRW38,000 (KRW33,000 previously); the only shipbuilder likely to achieve more than its new order target

We believe SHI's shipbuilding business will benefit from the gradual recovery of the offshore industry and LNG markets. We upgrade the stock to Overweight (V) from Neutral with a new target price of KRW38,000.

We prefer SHI to its peers owing to: 1) better LNG-FPSO and offshore production exposure, 2) lower risk from payment delays; and 3) it is more likely to achieve 2012 new order target than peers.

In the current sluggish market, we believe SHI is relatively better positioned than its Korean peers to deliver better-than-expected new orders in 2012 at USD12.5bn, given larger exposure to more probable offshore projects. The valuation also looks undemanding, given that the company has not undertaken asset revaluation.

The only yard to surpass its target

SHI set a 2012 new order target of USD12.5bn, up 9% from 2011's USD11.5bn. In 2011, the company won USD15bn of new orders, surpassing the target on the back of strong order momentum of LNGC and drillship. We believe SHI is likely to achieve its new order target in 2012 again as it has more remaining options from 2011 (see table) than peers and better LNG-FPSO exposure.

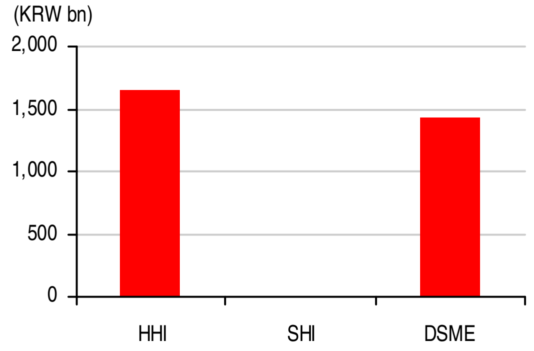
The company has already secured options worth USD5.8bn, accounting for approximately 46% of its annual target. These options include seven drillships, six LNGCs and four shuttle tankers. Besides, the yard has strong exposure to offshore and LNG operations, including FPSOs from Egina and Ichthys projects, LNG FPSOs from Shell and Petrobras, and some other FPU and fixed platforms.

Korean Big3 Yard: Remaining options

	Big3		SHI		DSME		HHI	
	Unit	USbn	Unit	USD bn	Unit	USDbn	Unit	USDbn
Drillship	10	6.0	7	4.2	2	1.2	1	0.6
Semi sub	2	1.1			2	1.1		
LNGC	14	2.8	6	1.2	6	1.2	2	0.4
Others	6	0.6	4	0.4			2	0.2
Total	**32**	**10.5**	**17**	**5.8**	**10**	**3.5**	**5**	**1.2**

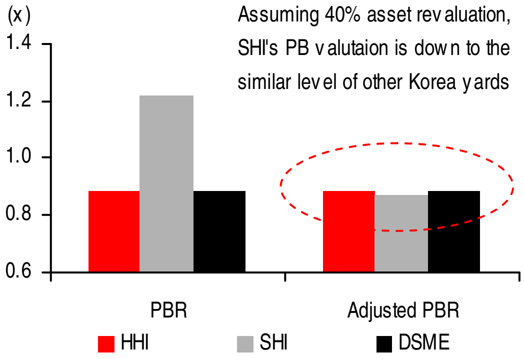
Source: Company data, HSBC

Korea Big3 Shipbuilders: Long-term account receivables



Source: Company data as of 3Q11

Korea Big3: Adjusted PB valuation



Source: Bloomberg, HSBC

We strongly believe the company will easily achieve its target on the back of these options and offshore projects.

The company also has lower exposure to payment delay risk. Delayed payments of already delivered vessels are usually booked as long-term account receivables. Compared to its peers, Samsung Heavy reported the lowest level of long-term account receivables. This suggests there would be limited downside risk to its earnings.

In terms of valuation, we believe the company deserves a valuation premium due to its strong offshore track record. Furthermore, given that the company has not undertaken asset revaluation, it is trading at a similar level to peers on an adjusted basis given that other shipbuilders revalued their book value in 2009, increasing their equities by approximately 40%.

In this regard, we upgrade the stock to Overweight (V) from Neutral and prefer Samsung Heavy to its peers in the sector.

Earnings forecast revisions

We raised SHI's top line by 10% and 6% in 2012e and 2013e due to IFRS conversion, leading to a change in the figures to a consolidated basis. We also adjust 2013 operating margin to 7.6% from 6.7% (2012e OPM remains unchanged at 6.5%), as it has the highest exposure to the LNG and offshore markets among peers. Also, we raise net profit by 0.7% and 4.6% in 2012-13e, respectively.

Switch from K-GAAP to K-IFRS

We have revisited our estimates due to the switch from K-GAAP to K-IFRS. We now forecast sales numbers on a K-IFRS consolidated basis. We raise our sales number by 10% and 6% for 2012 and 2013 to reflect its affiliates' sales numbers. Its operating profit includes affiliate earnings, so we have raised our forecast by 9% and 19% for 2012 and 2013. However, we have slightly raised net profit by 0.7% and 4.6% for 2012-13e, as net income under K-GAAP also included most of the major affiliate contribution via equity income.

SHI: Earnings forecast revisions

	New		Old		Chg		Consensus	
(KRWbn)	2012e	2013e	2012e	2013e	2012e	2013e	2012e	2013e
Sales	13,824	14,411	12,534	13,614	10.3%	5.9%	13,425	14,024
Operating profit	894	1,091	818	915	9.3%	19.2%	850	1,031
OPM	6.5%	7.6%	6.5%	6.7%			6.3%	7.3%
Net profit	740	888	735	849	0.7%	4.6%	709	857
NPM	5.4%	6.2%	5.9%	6.2%			5.3%	6.1%

Source: Bloomberg, HSBC

HSBC

Valuation and risk

We upgrade SHI to Overweight (V) from Neutral and raise our PB-based target price to KRW38,000 from KRW33,000. We apply a multiple of 1.5x to its 2012e book value, reflecting the cyclical nature of the shipbuilding industry.

Our new target price is derived from applying 1.5x to 2012e BVPS of KRW24,324. We arrive at 1.5x PB multiple with ROE of 14.0%. At our target price of KRW38,000, the shares would trade at 11.9x 2012e EPS. Given that the company should be able to maintain a strong orderbook with orders for deep sea oil and gas equipment (e.g. drill ships and semi-submersible rigs), we believe higher valuations, relative to peers, are warranted.

Under our research model, for Korea stocks with a volatility indicator the Neutral band is 10ppt above and below the hurdle rate of 10.5%. This translates into a Neutral band of 0.5-20.5%. As our target price implies a potential return of 29.1% (including dividend yield), above the Neutral band, we upgrade SHI to Overweight (V). We add the volatility flag in recognition of the stock's historical volatility having increased. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

SHI: Valuation summary

2012e BVPS	24,324
Target PB	1.5x
COE	9.1%
Sustainable RoE	14.0%
Target price (KRW)	38,000

Source: HSBC estimates.

Key upside risks: 1) a sharp recovery in the global economy, leading to a pick-up in new orders, 2) a newbuild price rebound, with stronger-than-expected order volume; and 3) strong commodity prices owing to better-than-expected offshore order volume.

Key downside risks: 1) falling oil prices, leading to lower offshore and tanker orders; 2) order book execution risk, and 3) a higher-than-expected rise in raw material costs.

SHI: Potential new orders and offshore projects (USD bn)

SHI					
2012 Target					**12.5**
Potential new orders (Option + Offshore PJT)					
Remaining options					**5.8**
Vessel type	Units	Vessel price		Contract Value	
Drillship	7	0.6		4.2	
LNGC	6	0.2		1.2	
Shuttle tanker	4	0.1		0.4	
Potential offshore production projects under bidding					**22.8**
Project	Region	Developer	Type	Contract Value	
Santos Basin	Brazil	Petrobras	LNG FPSO	4.0	
Ichthys	Autralia	Inpex	Oil FPSO / Gas CPF	4.0	
			Onshore Module	1.5	
Western Isles	UK	KNOC	Oil FPSO	0.6	
Egina	Nigeria	Total	Oil FPSO	2.0	
Shtokman	Russia	Gazprom	FPU	1.5	
Brouse	Australia	Woodside	Fixed Platform	0.7	
Moho Nord	Congo	Total	TLWP	1.0	
Block B	Vietnam	Chevron	Fixed Platform	1.0	
Shell FLNG	-	Shell	LNG FPSO	4.0	
Adabi	Malaysia	Inpex	LNG FPSO	2.0	
Malikai	Malaysia	Shell	TLP	n.a	
Water standard	Malaysia	-	EOR Vessel	n.a	

Source: Company data, Ship news, HSBC.

HSBC

Financials & valuation: Samsung Heavy Industries

Overweight (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (KRWb)				
Revenue	23,261	13,025	13,824	14,411
EBITDA	2,310	1,489	1,241	1,459
Depreciation & amortisation	-630	-343	-347	-368
Operating profit/EBIT	1,680	1,147	894	1,091
Net interest	-76	27	63	62
PBT	2,776	1,084	977	1,173
HSBC PBT	2,776	1,084	977	1,173
Taxation	-521	-262	-236	-284
Net profit	2,254	821	740	888
HSBC net profit	2,254	822	741	889
Cash flow summary (KRWb)				
Cash flow from operations	3,037	1,582	160	160
Capex	-565	-500	-500	-500
Cash flow from investment	-383	-498	-589	-575
Dividends	-97	-115	-107	-96
Change in net debt	-2,020	-446	78	26
FCF equity	1,617	1,021	259	6
Balance sheet summary (KRWb)				
Intangible fixed assets	1,216	162	171	178
Tangible fixed assets	6,098	5,097	5,435	5,377
Current assets	4,584	12,621	13,413	14,253
Cash & others	2,256	1,492	1,431	1,421
Total assets	18,625	19,258	20,476	21,332
Operating liabilities	6,080	8,527	9,279	9,502
Gross debt	2,884	1,673	1,690	1,707
Net debt	628	182	260	286
Shareholders funds	9,661	4,983	5,616	6,408
Invested capital	3,562	7,862	8,309	8,886

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	26.3	-44.0	6.1	4.2
EBITDA	26.4	-35.5	-16.7	17.6
Operating profit	46.8	-31.7	-22.0	22.0
PBT	63.3	-61.0	-9.9	20.1
HSBC EPS	55.4	-63.6	-9.9	20.1
Ratios (%)				
Revenue/IC (x)	5.7	2.3	1.7	1.7
ROIC	37.8	15.6	8.6	9.9
ROE	26.5	11.2	14.0	14.8
ROA	11.7	4.5	3.8	4.3
EBITDA margin	9.9	11.4	9.0	10.1
Operating profit margin	7.2	8.8	6.5	7.6
EBITDA/net interest (x)	30.5			
Net debt/equity	6.5	3.7	4.6	4.5
Net debt/EBITDA (x)	0.3	0.1	0.2	0.2
CF from operations/net debt	483.8	869.1	61.7	55.9
Per share data (KRW)				
EPS Rep (fully diluted)	9262.11	2880.27	2446.21	3005.41
HSBC EPS (fully diluted)	9763.93	3554.97	3204.37	3848.28
DPS	500.00	500.00	461.69	416.16
Book value	41846.06	21581.80	24324.25	27756.17

Valuation data

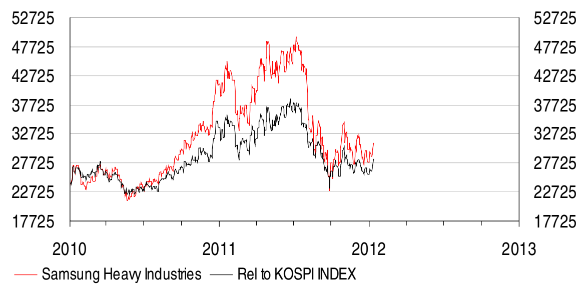
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	0.3	0.5	0.5	0.5
EV/EBITDA	3.4	4.7	5.7	4.8
EV/IC	2.2	0.9	0.8	0.8
PE*	3.2	8.8	9.7	8.1
P/Book value	0.7	1.4	1.3	1.1
FCF yield (%)	22.4	15.0	3.8	0.1
Dividend yield (%)	1.6	1.6	1.5	1.3

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (KRW)	31,200	Target price (KRW)	38,000
Reuters (Equity)	010140.KS	Bloomberg (Equity)	010140 KS
Market cap (USDm)	6,243	Market cap (KRWb)	7,203
Free float (%)	64	Enterprise value (KRWb)	6985
Country	Korea	Sector	MACHINERY
Analyst	Paul Choi	Contact	+822 3706 8758

Price relative



Source: HSBC

Note: price at close of 11 Jan 2012

HSBC

DSME (042660)

- Strong offshore and LNG segments offset the lacklustre commercial vessel market
- Margin contraction to continue until 2012e, along with earnings risk from several payment delay contracts
- Remain Neutral (V); PB-based target price of KRW27,000 (KRW30,000 previously)

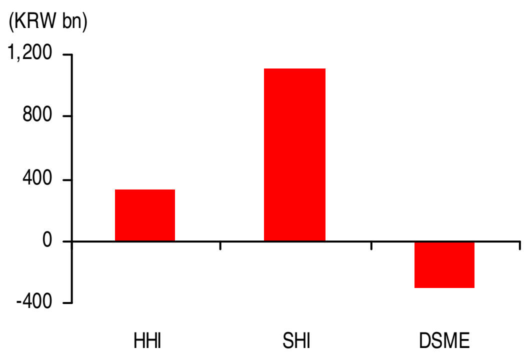
We maintain Neutral (V) on Daewoo Shipbuilding & Marine Engineering (DSME) with a new target price of KRW27,000. Despite its strong position in the offshore and LNG markets, we do not believe DSME can avoid the repercussions of the current industry downturn. It faces pricing risk from stressed earnings from the shipbuilding industry as well as increased competition from major peers. We think competition will lower the profitability of overall industry.

We believe DSME's shipbuilding business will benefit from the gradual recovery of the offshore industry and LNG markets. Despite better sentiment and higher expectations, we think the increased optimism is already reflected in SHI's share price.

We expect offshore new orders will remain flat in 2012, which could be below the last peak cycle average at new orders of over 30 units per annum. Our view still supports that healthy day rates and utilisation rates of drilling units should trigger solid demand. However, this does not mean that we are expecting a sharp rise in new orders or a return to the peak cycle similar to 2007 any time soon.

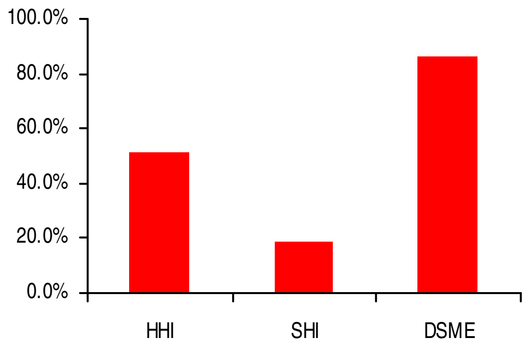
The major reasons why we prefer SHI over DSME are: 1) higher risk from payment delays; 2) overhang issue from KAMCO; and 3) lack of new orders from offshore to achieve its annual target in 2012.

Korea Big3: Operating cash flow



Source: Company data, as of 3Q11

Korea Big 3: Net debt to equity



Source: Company data, as of 3Q11

Payment delays, cancellation and overhang issue

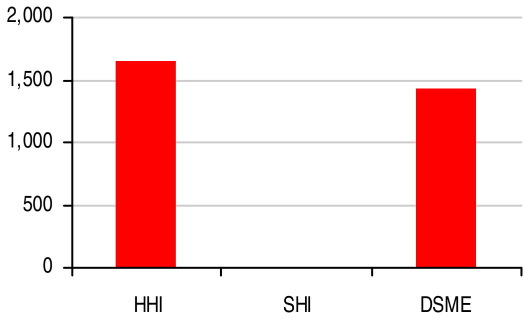
We are becoming more pessimistic about the yard's profitability as some clients are asking for payment delays. In 2010, we think the yard had to delay the payment schedule for some foreign clients suffering from lack of financing. We also believe the shipbuilder is likely to negotiate payment delays even for domestic clients. As a result, its working capital and debt level deteriorated dramatically in 3Q11.

It appears that the yard is delaying payments over 3-5 years even on vessels already delivered. This is quite surprising given we did not see this trend back in 2009. The delayed payment for delivered vessels is booked as long-term account receivables and as of end 3Q11, it was KRW1.4bn. We believe this could be a potential risk to DSME's earnings.

Besides, DSME recently reported that orders for two bulkers and two VLCCs worth USD521m were cancelled by a European client due to payment issues. These orders were placed in 2008 when vessel prices were at record high levels. However, vessel prices have already fallen massively and we do not expect further cancellation on vessels placed in 2010-11.

Along with the long-term receivable risk and order cancellations, KAMCO recently announced it was disposing its 19.1% stake in DSME by block sale. We think this overhang could be a risk to the stock performance.

Korea Big 3 shipbuilders: Long-term account receivables



Source: Company data as of 3Q11

Earnings forecast revisions

We raise DSME's top line by 11% and 13% in 2012 and 2013, mainly due to IFRS conversion, leading to a change to a consolidated basis from a parent basis. We lower operating margin to 6.1% and 6.6% from 7.1% and 7.3% in 2012-13e, respectively. We also lower net profit by 14% and 7% in 2012-13e, respectively.

Switch from K-GAAP to K-IFRS

We have revisited our estimates due to the switch from K-GAAP to K-IFRS. We now forecast sales numbers on a K-IFRS consolidated basis.

We have raised sales forecasts by 11-13% in 2012-13 to reflect its affiliates' sales numbers. Its operating profit also includes earnings from affiliates, so we have changed our operating profit forecast by -4% for 2012 and 3% for 2013. However, we have cut net profit by 14% and 7% for 2012-13e, as the previous net income under K-GAAP also included most of its affiliate contribution via equity income.

DSME: Earnings forecast revisions

	New		Old		Chg		Consensus	
(KRWbn)	2012e	2013e	2012e	2013e	2012e	2013e	2012e	2013e
Sales	13,440	13,608	12,143	12,076	10.7%	12.7%	13,201	13,709
Operating profit	826	901	862	877	-4.2%	2.7%	754	863
OPM	6.1%	6.6%	7.1%	7.3%			5.7%	6.3%
Net profit	575	646	670	697	-14.3%	-7.3%	540	656
NPM	4.3%	4.7%	5.5%	5.8%			4.1%	4.8%

Source: Bloomberg, HSBC estimates.

Valuation and risks

We remain Neutral (V) on DSME but lower our target price to KRW27,000 from KRW30,000 based on PB valuation. We apply a multiple of 1.0x to its 2012e book value of KRW27,428.

Our new target price is derived from applying 1.0x to 2012e BVPS of KRW27,428. We arrive at 1.0x PB multiple with ROE of 11.9%. At our target price of KRW27,000, it would trade at 8.9x 2012e EPS.

DSME: Valuation summary

2012e BVPS	27,428
Target PB	1.0x
COE	11.8%
Sustainable ROE	11.9%
Target Price (KRW)	27,000

Source: HSBC estimates.

Under our research model, for Korea stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate of 10.5%. This translates into a Neutral band of 0.5-20.5%. As our target price implies a potential return of 15.8% (including dividend yield), within the Neutral band, we remain Neutral (V) on DSME. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key upside risks: 1) a sharp recovery in the global economy, leading to a pick-up in new orders, 2) a newbuild price rebound, with stronger-than-expected order volume, and 3) strong commodity prices owing to better-than-expected offshore order volume.

Key downside risks: 1) falling oil prices, leading to lower offshore and tanker orders; 2) order book execution risk, 3) a higher-than-expected rise in raw material costs, and 4) overhang issue on KAMCO's stake.

DSME: Potential new orders and offshore projects (USD bn)

DSME						
2012 target						11.0
Potential new orders (Option + Offshore PJT)						
Remaining options					3.5	
	Vessel type	Units	Vessel price	Contract Value		
	Drillship	2	0.6	1.2		
	LNGC	6	0.2	1.2		
	Semi-Sub	2	0.1	1.1		
Potential offshore production project under bidding					17.6	

Project	Region	Developer	Type	Contract Value
Ichthys	Autralia	Inpex	Oil FPSO / Gas CPF	4.0
			Onshore module	2.0
Wheatstone	Autralia	Chevron	LNG Offshore	1.4
Shtokman	Russia	Gazprom	FPU	1.5
Brouse	Autralia	Woodside	Fixed Platform	0.7
Petronas FLNG	Malaysia	Petronas	LNG FPSO	1.5
Moho Nord	Congo	Total	TLWP	1.0
Block B	Vietnam	Chevron	Fixed Platform	1.0
Petromin	Papua New Guinea	Petromin	LNG FPSO	2.5
Tamar	Israel	Noble, Delek, Isramco	LNG FPSO	2.0

Source: Company data, Ship news, HSBC

Financials & valuation: Daewoo Shipbuilding & Marine

Neutral (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (KRWb)				
Revenue	23,261	13,399	13,440	13,608
EBITDA	2,310	1,658	1,176	1,266
Depreciation & amortisation	-630	-346	-350	-365
Operating profit/EBIT	1,680	1,312	826	901
Net interest	-76	-95	-66	-49
PBT	2,776	1,212	759	853
HSBC PBT	2,776	1,212	759	853
Taxation	-521	-293	-184	-206
Net profit	2,254	918	575	646
HSBC net profit	2,254	919	575	647
Cash flow summary (KRWb)				
Cash flow from operations	3,037	-382	779	691
Capex	-565	-500	-500	-500
Cash flow from investment	-383	-552	-510	-514
Dividends	-97	-96	-115	-72
Change in net debt	-2,020	2,503	-568	-456
FCF equity	1,617	-684	397	348
Balance sheet summary (KRWb)				
Intangible fixed assets	1,216	129	143	155
Tangible fixed assets	6,098	5,239	5,450	5,504
Current assets	4,584	9,780	9,474	9,423
Cash & others	2,256	894	799	767
Total assets	18,625	17,317	17,242	17,283
Operating liabilities	6,080	6,807	6,840	6,574
Gross debt	2,884	4,026	3,362	2,875
Net debt	628	3,131	2,563	2,107
Shareholders funds	9,661	4,816	5,185	5,758
Invested capital	3,562	7,448	7,428	7,740

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	26.3	-42.4	0.3	1.3
EBITDA	26.4	-28.2	-29.1	7.6
Operating profit	46.8	-21.9	-37.1	9.1
PBT	63.3	-56.3	-37.4	12.4
HSBC EPS	55.4	-59.3	-37.4	12.4
Ratios (%)				
Revenue/IC (x)	5.7	2.4	1.8	1.8
ROIC	37.8	18.3	8.6	9.2
ROE	26.5	12.7	11.5	11.8
ROA	11.7	5.8	3.9	4.3
EBITDA margin	9.9	12.4	8.8	9.3
Operating profit margin	7.2	9.8	6.1	6.6
EBITDA/net interest (x)	30.5	17.4	17.8	26.0
Net debt/equity	6.5	65.0	49.4	36.6
Net debt/EBITDA (x)	0.3	1.9	2.2	1.7
CF from operations/net debt	483.8		30.4	32.8
Per share data (KRW)				
EPS Rep (fully diluted)	11422.52	4180.63	2280.77	2573.61
HSBC EPS (fully diluted)	11924.61	4855.33	3038.93	3416.48
DPS	506.94	506.94	609.94	381.76
Book value	51104.83	25477.07	27427.62	30457.61

Valuation data

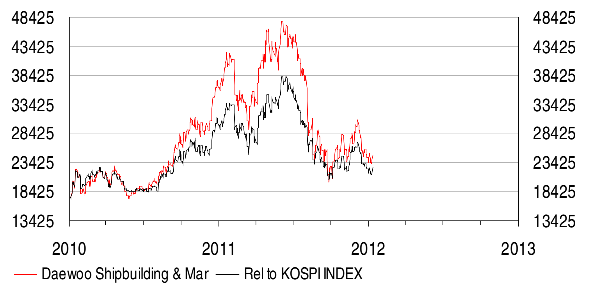
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	0.2	0.6	0.5	0.5
EV/EBITDA	2.3	4.6	6.0	5.2
EV/IC	1.5	1.0	1.0	0.9
PE*	2.1	5.1	8.2	7.3
P/Book value	0.5	1.0	0.9	0.8
FCF yield (%)	34.1	-15.2	8.8	7.7
Dividend yield (%)	2.0	2.0	2.5	1.5

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (KRW)	24,800	Target price (KRW)	27,000
Reuters (Equity)	042660.KS	Bloomberg (Equity)	042660 KS
Market cap (USDm)	4,114	Market cap (KRWb)	4,746
Free float (%)	64	Enterprise value (KRWb)	7635
Country	Korea	Sector	MACHINERY
Analyst	Paul Choi	Contact	+822 3706 8758

Price relative



Source: HSBC

Note: price at close of 11 Jan 2012

Hyundai Mipo Dockyard (010620)

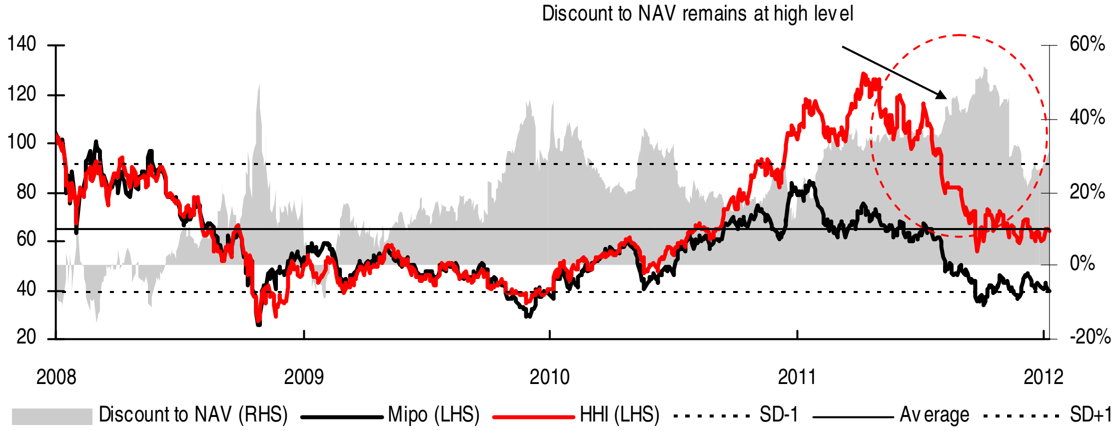
- Sluggish bulkers and tanker market
- Despite applying zero value to operation, the stock is trading at a deep discount to NAV
- Maintain Overweight (V); SOTP-based TP of KRW135,000 (KRW140,000 previously)

We reiterate Overweight (V) on Hyundai Mipo with a new target price of KRW135,000, which is derived from a sum-of the parts (SOTP) valuation. We believe SOTP best captures the NAV given the company's various investment assets such as Hyundai Heavy Industries and net cash at KRW606bn. Our target price translates into implied 2012e PE and PB of 10.1x and 0.6x, respectively, suggesting a potential return of c24.0%.

NAV breakdown

Shipbuilding business is still the key earnings driver of Mipo, consisting of bulker at 47% and product tanker at 22% of current orderbook. In NAV terms, its core business represents 46% of total NAV, if we apply 6x 2012e EV/EBITDA. However, we applied zero multiple to reflect Mipo's high exposure to sluggish bulker and tanker markets. Its non-core assets are valued at KRW2.0rn after applying a 50% discount to their

Mipo's historical discount to NAV trend



Source: HSBC

values. Thus, we believe zero operation value could provide the floor value of the company.

Sum-of-the-parts valuation summary

In our NAV calculation, we value the core operations at zero. We apply a 50% discount to the non-core assets (KRW2.0trn), including the equity-method requirement for subsidiary value and holdings of marketable securities in order to reflect the effect from the corporate tax when liquidated. Lastly, we add estimated 2012e net cash of KRW606bn.

For the core operations, we applied zero EV/EBITDA multiple to reflect our conservative stance on bulker and tanker segments. Given these market conditions should recover at some point in time in the future, we reckon that the current valuation is extremely conservative and should provide further upside in the future. Our sensitivity shows that fair value of the company should increase to KRW304,000, if we were to apply 6.0x EV/EBITDA.

Mipo is not a legislative holding company, but we believe that SOTP valuation best captures its true NAV given the strong cash position and non-core investment holdings.

Operating multiple sensitivity analysis

Multiple (2012e)	Target price	Potential upside
0.0x EV/EBITDA	135,000	25.0%
2.0x EV/EBITDA	192,000	77.8%
4.0x EV/EBITDA	248,000	129.6%
6.0x EV/EBITDA	304,000	181.5%

Source: HSBC estimates.

For non-core assets, we incorporate the book value of unlisted subsidiaries for which equity-method accounting is required as of 3Q11; this excludes listed companies including Hyundai Heavy for which we apply the current market cap and the market value of holdings of marketable securities. For the per share value, we applied a number of shares after deducting the number of treasury stocks (409,596) from total outstanding shares (19.6mn).

Discount to NAV nearing peak level

The discount to NAV widened in 2010-11 when Hyundai Heavy was re-rated by the market due to strong performance of non-shipbuilding divisions. Its discount rate has surged to as high as 45% in 2010, while the average discount rate was 8% for

Hyundai Mipo - Valuation and NAV Discount

Operating Value (KRW bn)						**0**
2012e EBITDA (KRW bn)					377	
EV/EBITDA multiple (x)					0.0x	
Non-operating (KRW bn)						**2,042**
	#of shares	% stake	Share Px	Discount	Value	
Hyundai Heavy	6,063,000	7.98%	273,000	50%	819	
Posco	872,000	1.00%	378,500	50%	163	
KCC	397,000	3.77%	279,000	50%	55	
KoEnTech	1,648,000	3.30%	3,070	50%	3	
Other not listed available-for-sales				50%	9	
Equity method securities				50%	992	
2011e Net debt (KRW bn)						**-606**
Total Equity Value (KRW bn)						**2,647**
Total shares (Shares)					20,000,000	
Treasury share (Shares)					409,596	
Share outstanding (Shares)						19,590,404
Target price (KRW)						**135,000**
Current share price (KRW)						110,500
Potential Upside (%)						24%

Source: Company data, HSBC estimates.

* Note: price as of 10 Jan 2012.

Mipo: Earnings forecast revisions

(KRWbn)	New 2012e	New 2013e	Old 2012e	Old 2013e	Chg 2012e	Chg 2013e	Consensus 2012e	Consensus 2013e
Sales	3,827	3,688	4,001	3,983	-4.4%	-7.4%	4,077	4,129
Operating Profit	325	323	366	369	-11.2%	-12.6%	348	377
OPM	8.5%	8.7%	9.1%	9.3%			8.5%	9.1%
Net Profit	305	308	297	303	2.7%	1.8%	349	367
NPM	8.0%	8.4%	7.4%	7.6%			8.6%	8.9%

Source: Bloomberg, HSBC estimates.

the past 5 years. The discount generally remained range-bound between -33-33% until the financial crisis hit the market in 2H08; the discount rate has once again hit a record-high level of 33% in 2008.

Earnings forecast

We expect revenue to decline 4.4% in 2012 and 7.4% in 2013, mainly due to increasing ship construction and the continuing recovery of new orders. We expect new orders to remain flat for the next couple of years.

Our operating margins for 2012 stand at 8.5% and 8.7% in 2012-13e, slightly lower than the market consensus of 8.5% and 9.7% in 2012/13e, respectively. Also our operating profit estimate is 7% below market consensus for 2012e.

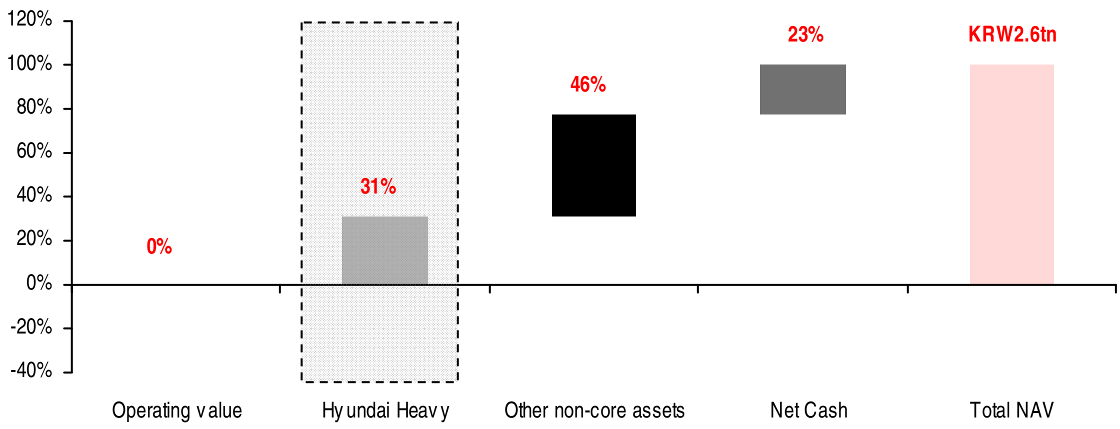
Valuation and risks

We remain Overweight (V) on Hyundai Mipo but lower our target price to KRW135,000 from KRW140,000, based on sum-of-the-parts valuation. Under our SOTP valuation, we apply zero operational value on its commercial shipbuilding due to weak industry trend on bulkers and tankers. We believe SOTP is an appropriate valuation methodology given Mipo's various investment assets.

In our NAV calculation, we value its core operations at zero. We apply a 50% discount to the non-core assets (KRW2.0tn), including the equity-method requirement for subsidiary value and holdings of marketable securities in order to reflect the effect from the corporate tax when liquidated. Lastly, we add estimated 2012e net cash of KRW 606tn.

Under our research model, for Korea stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate of 10.5%. This translates into a Neutral band of 0.5-20.5%. As our target price implies a potential return of 24% (including dividend

NAV decomposition



Source: HSBC

yield), above the Neutral band, we reiterate OW(V) on Mipo. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks: 1) falling oil prices, leading to lower tanker orders; 2) order book execution risk, and 3) higher-than-expected raw material costs hike.

Key upside risks: 1) a sharp recovery in the global economy, leading to a pick-up in new orders, 2) a newbuild price rebound with stronger-than-expected order volume, and 3) strong commodity prices with better-than-expected bulker and tanker orders.

Financials & valuation: Hyundai Mipo Dockyards

Overweight (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (KRWb)				
Revenue	3,739	4,155	3,827	3,688
EBITDA	585	504	377	376
Depreciation & amortisation	-38	-49	-52	-54
Operating profit/EBIT	547	455	325	323
Net interest	33	28	22	21
PBT	592	528	399	402
HSBC PBT	592	528	399	402
Taxation	-139	-123	-93	-94
Net profit	454	404	305	308
HSBC net profit	454	404	305	308
Cash flow summary (KRWb)				
Cash flow from operations	622	-416	-38	576
Capex	-71	-72	-72	-73
Cash flow from investment	-830	204	-73	-73
Dividends	-58	-69	-46	-46
Change in net debt	-248	562	53	-653
FCF equity	450	-239	-49	392
Balance sheet summary (KRWb)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	575	597	618	637
Current assets	2,497	2,251	2,361	2,964
Cash & others	1,221	659	606	1,259
Total assets	7,530	7,378	7,515	8,146
Operating liabilities	2,700	2,214	1,994	2,171
Gross debt	0	0	0	0
Net debt	-1,221	-659	-606	-1,259
Shareholders funds	4,209	4,551	4,810	5,073
Invested capital	-850	-25	378	171

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	0.8	11.1	-7.9	-3.6
EBITDA	36.2	-13.7	-25.3	-0.1
Operating profit	41.2	-16.8	-28.5	-0.8
PBT	18.4	-10.9	-24.5	0.9
HSBC EPS	19.8	-17.4	-24.5	0.9
Ratios (%)				
Revenue/IC (x)	-4.2	-9.5	21.7	13.4
ROIC	-46.6	-79.6	141.0	90.0
ROE	13.3	9.2	6.5	6.2
ROA	6.7	5.4	4.1	3.9
EBITDA margin	15.6	12.1	9.8	10.2
Operating profit margin	14.6	10.9	8.5	8.7
EBITDA/net interest (x)				
Net debt/equity	-29.0	-14.5	-12.6	-24.8
Net debt/EBITDA (x)	-2.1	-1.3	-1.6	-3.3
CF from operations/net debt				
Per share data (KRW)				
EPS Rep (fully diluted)	21386.98	17669.19	13346.89	13470.35
HSBC EPS (fully diluted)	21386.98	17669.19	13346.89	13470.35
DPS	2000.00	2000.00	2000.00	2000.00
Book value	183934.60	198860.78	210207.67	221678.02

Valuation data

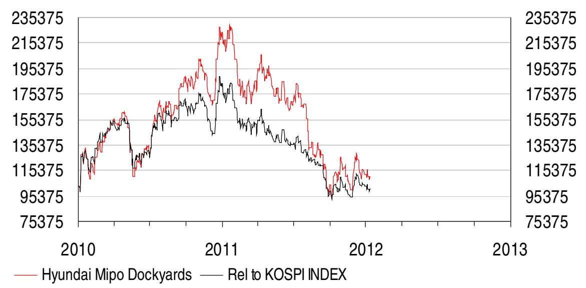
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	0.3	0.4	0.4	0.3
EV/EBITDA	1.7	3.0	4.2	2.5
EV/IC			4.2	5.5
PE*	5.1	6.2	8.2	8.1
P/Book value	0.6	0.6	0.5	0.5
FCF yield (%)	20.5	-10.9	-2.3	17.9
Dividend yield (%)	1.8	1.8	1.8	1.8

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price	(KRW)109500.00	Target price	(KRW)135000.00
Reuters (Equity)	010620.KS	Bloomberg (Equity)	010620 KS
Market cap (USDm)	1,898	Market cap (KRWb)	2,190
Free float (%)	50	Enterprise value (KRWb)	1531
Country	Korea	Sector	MACHINERY
Analyst	Paul Choi	Contact	+822 3706 8758

Price relative



Source: HSBC

Note: price at close of 11 Jan 2012

HSBC

China Rongsheng Heavy (1101)

- In 2011, Rongsheng received new orders of USD2.0bn, in line with our forecast
- Weak cash generation, execution ability and new orders are still concerns for investors
- Maintain Neutral (V); PB-based TP of HKD2.5 (HKD3.5 previously)

We maintain Neutral (V) on China Rongsheng Heavy Industry, as execution risk remains in its business expansion to become a heavy conglomerate. We need to see better visibility in newbuilding orders, better external engine sales and further market share gain in the highly competitive Chinese excavator market before we change our investment stance.

Recently, smaller Chinese yards are facing potential bankruptcy risks as they are not receiving new orders and burning cash rapidly. We think industry consolidation could be a potential opportunity for Rongsheng, assuming the company is free from bankruptcy risks. Traditionally, the Chinese government does not want to abandon the shipbuilding industry, as in case of Korea and Japan in the past, as this sector has generally provided significant employment opportunities.

Rongsheng is shipyard based in Jiangsu with current backlog at USD6.7bn (17m DWT). The current backlog makes this company the biggest private shipyard in China. The current backlog mostly consists of bulkers and tankers; however, the company is targeting to gradually move toward offshore products and larger size containerships and LNG carriers; however, we do not think the company will be able to enter this market in the near future, given the lack of track record.

Shipbuilding

Rongsheng has won new orders of USD2.0bn in 2011, in line with our forecast. However, this actually missed its initial target of USD3.3bn.

For 2012, we expect the company to receive 400k CGT new orders of both tankers and bulkers, although this is not a very meaningful recovery. For containers, the company mentioned that it is currently under negotiation for 9,000-10,000 TEU and hopes to get these orders in 2012.

On LNGC side, Rongsheng was selected last summer as one of the three candidates for LNG projects led by Chinese oil majors. In fact, the company said in August 2011 that it was expecting to win orders of 6-8 units by the end of 2011; however, it recently announced that it is expecting these orders in 2012. We believe if the company clinches these projects from Chinese oil majors like PetroChina, CNOOC or Sinopec, it

could regain investors' confidence which may have a positive impact on its share price.

Non-shipbuilding

We believe that the offshore segment will be the key growth driver for the company in the future. Players in China including Cosco, Yangzijiang, CSSC, CSIC as well as Rongsheng are hoping to benefit from the offshore market They are aggressively targeting more offshore orders on the back of CNOOC's production target of 1m bpd by 2020 from deepwater fields. However, we will have to see more visibility on whether the Chinese yards can actually deliver better than market expectations by successfully building high-quality offshore vessels given their weak track record.

In the construction equipment division, the company completed the 1st phase of building excavator production capacity of 16,000 units. However, the company only sold less than 1,500 units in 2011. We believe Rongsheng can sell up to only 2,000 units next year as the competitors are aggressively offering leasing products, while, in our view, Rongsheng is not able to offer the lease service due to the lack of cash. According to the company, its main product is 20-30 ton excavators and they are sold at around RMB400-450k, which is well below the industry leaders' of around RMB700-800k.

Weak cash generation is a major concern

The company's cashflow has turned negative to RMB9.6bn in 2010 and RMB 6.6bn in 1H11, as it spent over RMB220m of capex over the past two years to ramp up production facility. Another reason for its negative operating cashflow trend is the payment method offered to clients. According to the company, most of contracts are 'heavy tail' payment method, in which they collect 50-60% cash upon delivery. We believe the 'heavy tail' method, lack of new orders and delivery delay could lead to continuing cash burn for the next couple of quarters.

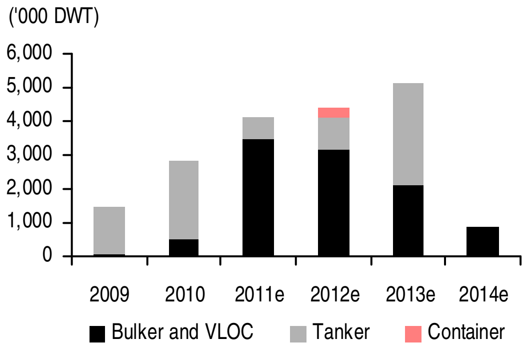
We forecast free cash flow to improve to RMB773m in 2012. Once the company generates positive free cashflow and solid return through further market share gains in rapidly growing heavy industries, we believe the stock will gain momentum.

Earnings forecast

We expect revenue to grow 8% both in 2012/13, due to increased vessel construction. We expect new order growth of 10%/17% in 2012/13. However, we do not believe new orders will be enough to maintain Rongsheng's order backlog above 2.5x.

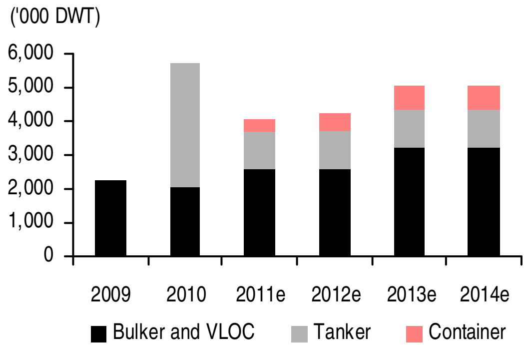
Our operating margins for 2012e stand at 13.3% against consensus of 15.4%, as we are more concerned about current margins as well as the profitability of recent new orders. Our operating

Jiangsu Rongsheng delivery from current backlog



Source: Company data, Clarkson, HSBC estimates

Jiangsu Rongsheng new orders



Source: Company data, HSBC estimates

Rongsheng: Earnings forecast revisions

(RMBm)	New 2012e	New 2013e	Old 2012e	Old 2013e	Chg 2012e	Chg 2013e	Consensus 2012e	Consensus 2013e
Sales	20,248	21,879	23,323	25,965	-13.2%	-15.7%	21,928	23,768
Operating Profit	2,700	2,823	4,180	4,759	-35.4%	-40.7%	3,385	3,479
OPM	13.3%	12.9%	17.9%	18.3%			15.4%	14.6%
Net Profit	2,200	2,034	3,495	3,486	-37.1%	-41.6%	2,749	2,867
NPM	10.9%	9.3%	15.0%	13.4%			12.5%	12.1%

Source: Bloomberg, HSBC estimates.

profit estimate is 20%/19% below market consensus for 2012/13e.

Valuation and risks

We maintain Neutral (V) on Rongsheng Heavy and lower our PB-based target price to HKD2.5 from HKD3.5. We believe ROE-PB valuation is the best methodology given its over-95% shipbuilding exposure. We apply a PB multiple of 0.8x (sustainable ROE: 12%; COE: 15.1%; g: 3%) to its 2012e book value of Rmb2.76. At our target price of HKD2.5, the shares would trade at 6.8x 2012e EPS.

Rongsheng Heavy: Valuation summary

2012e BVPS (Rmb)	**2.76**
HKD/Rmb	1.22
2012e BVPS (HKD)	**3.37**
Target PB	0.8
CoE	15.1%
Sustainable RoE	12.0%
Growth	3.0%
Target Price (HKD)	**2.5**

Source: Bloomberg, HSBC estimates.

Under our research model, for Hong Kong stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate of 8.5%. This translates into a Neutral band of -1.5-18.5%. As our target price implies a potential return of 14.9% (including dividend yield), within the Neutral band, we maintain Neutral (V) on the stock. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks: 1) falling oil prices, leading to lower tanker orders; 2) order book execution risk, and 3) a higher-than-expected rise in raw material costs.

Key upside risks: 1) a sharp recovery in the global economy, leading to a pick-up in new orders, 2) a newbuild price rebound with stronger-than-expected order volume, and 3) strong commodity prices with better-than-expected bulker and tanker orders.

Financials & valuation: China Rongsheng Heavy

Neutral (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (CNYm)				
Revenue	12,665	18,738	20,248	21,879
EBITDA	2,424	3,491	3,498	3,734
Depreciation & amortisation	-391	-625	-798	-910
Operating profit/EBIT	2,034	2,866	2,700	2,823
Net interest	10	-87	-186	-111
PBT	2,044	2,778	2,514	2,713
HSBC PBT	2,044	2,778	2,514	2,713
Taxation	-263	-347	-314	-678
Net profit	1,780	2,431	2,200	2,034
HSBC net profit	1,780	2,431	2,200	2,034
Cash flow summary (CNYm)				
Cash flow from operations	-3,382	1,712	2,589	2,948
Capex	-4,146	-4,000	-2,000	-2,000
Cash flow from investment	-6,209	-5,942	-1,813	-1,813
Dividends	-392	-608	-550	-509
Change in net debt	3,242	4,524	-403	-837
FCF equity	-7,494	-2,406	567	529
Balance sheet summary (CNYm)				
Intangible fixed assets	109	98	81	67
Tangible fixed assets	12,781	16,167	17,385	18,489
Current assets	27,954	23,391	21,598	21,253
Cash & others	14,423	6,899	4,302	3,139
Total assets	40,996	39,807	39,216	39,961
Operating liabilities	9,438	8,781	8,956	9,635
Gross debt	16,916	13,916	10,916	8,916
Net debt	2,493	7,017	6,614	5,777
Shareholders funds	13,859	16,196	18,312	20,268
Invested capital	16,983	23,975	25,806	27,034

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	33.7	47.9	8.1	8.1
EBITDA	52.0	44.0	0.2	6.7
Operating profit	48.7	40.9	-5.8	4.6
PBT	56.4	36.0	-9.5	7.9
HSBC EPS	32.6	12.4	-9.5	-7.5
Ratios (%)				
Revenue/IC (x)	1.5	0.9	0.8	0.8
ROIC	20.6	12.4	9.7	8.2
ROE	24.2	16.2	12.7	10.5
ROA	6.1	6.7	6.4	5.7
EBITDA margin	19.1	18.6	17.3	17.1
Operating profit margin	16.1	15.3	13.3	12.9
EBITDA/net interest (x)		40.1	18.8	33.7
Net debt/equity	17.0	41.0	34.2	27.0
Net debt/EBITDA (x)	1.0	2.0	1.9	1.5
CF from operations/net debt		24.4	39.1	51.0
Per share data (CNY)				
EPS Rep (fully diluted)	0.31	0.35	0.31	0.29
HSBC EPS (fully diluted)	0.31	0.35	0.31	0.29
DPS	0.07	0.09	0.08	0.07
Book value	2.54	2.44	2.76	3.06

Valuation data

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.2	1.1	1.0	0.8
EV/EBITDA	6.3	5.6	5.5	4.9
EV/IC	0.9	0.8	0.7	0.7
PE*	5.9	5.3	5.8	6.3
P/Book value	0.7	0.7	0.7	0.6
FCF yield (%)	-59.2	-19.0	4.5	4.2
Dividend yield (%)	3.7	4.7	4.3	4.0

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price	(HKD)	2.25	Target price	(HKD)	2.50
Reuters (Equity)		1101.HK	Bloomberg (Equity)		1101 HK
Market cap (USDm)		2,028	Market cap	(HKDm)	15,750
Free float (%)		43	Enterprise value	(CNYm)	19680
Country		Hong Kong	Sector		Machinery
Analyst		Paul Choi	Contact		+822 3706 8758

Price relative

Source: HSBC

Note: price at close of 11 Jan 2012

Notes

Disclosure appendix

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Rating definitions for long-term investment opportunities

Stock ratings

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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As of 12 January 2012, the distribution of all ratings published is as follows:

Overweight (Buy)	54%	(26% of these provided with Investment Banking Services)
Neutral (Hold)	35%	(20% of these provided with Investment Banking Services)
Underweight (Sell)	11%	(13% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Hyundai Mipo Dockyards (010620.KS) Share Price performance KRW Vs HSBC rating history

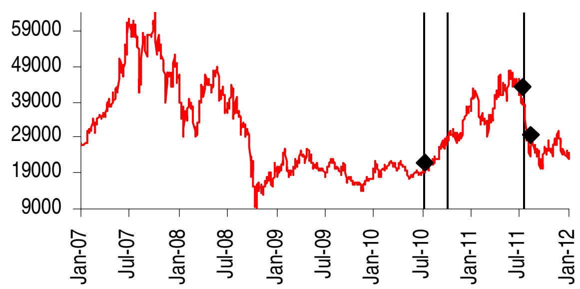
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight (V)	23 May 2011
Overweight (V)	Overweight	16 August 2011
Overweight	Overweight (V)	11 November 2011
Target Price	**Value**	**Date**
Price 1	230000.00	23 May 2011
Price 2	180000.00	16 August 2011
Price 3	140000.00	11 November 2011

Source: HSBC

Daewoo Shipbuilding & Mar (042660.KS) Share Price performance KRW Vs HSBC rating history



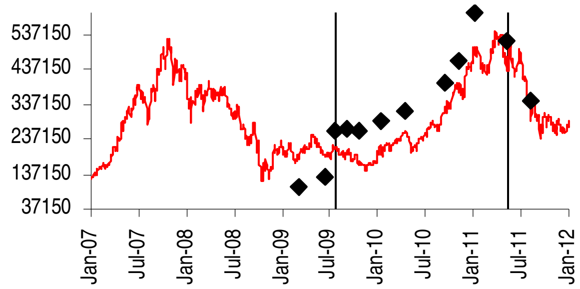
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral (V)	19 July 2010
Neutral (V)	Restricted	12 October 2010
Restricted	Neutral (V)	28 July 2011
Target Price	**Value**	**Date**
Price 1	22000.00	19 July 2010
Price 2	Restricted	12 October 2010
Price 3	43000.00	28 July 2011
Price 4	30000.00	23 August 2011

Source: HSBC

Hyundai Heavy Industries (009540.KS) Share Price performance KRW Vs HSBC rating history



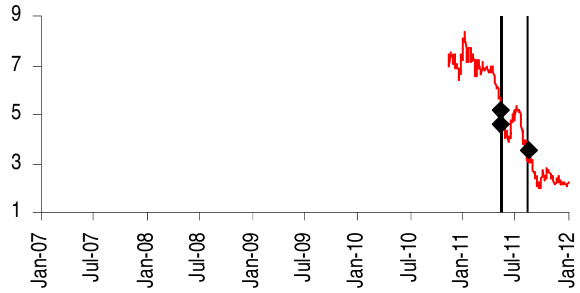
Source: HSBC

Recommendation & price target history

From	To	Date
Underweight (V)	Overweight (V)	31 July 2009
Overweight (V)	Neutral	23 May 2011
Target Price	**Value**	**Date**
Price 1	100000.00	18 March 2009
Price 2	130600.00	24 June 2009
Price 3	262000.00	31 July 2009
Price 4	269000.00	17 September 2009
Price 5	260000.00	29 October 2009
Price 6	290000.00	22 January 2010
Price 7	320000.00	22 April 2010
Price 8	400000.00	27 September 2010
Price 9	460000.00	17 November 2010
Price 10	600000.00	18 January 2011
Price 11	520000.00	23 May 2011
Price 12	350000.00	23 August 2011

Source: HSBC

China Rongsheng He (1101.HK) Share Price performance HKD Vs HSBC rating history



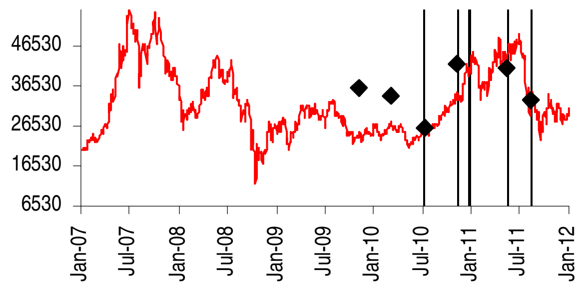
Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Underweight (V)	23 May 2011
Underweight (V)	Neutral (V)	24 August 2011
Target Price	**Value**	**Date**
Price 1	5.20	23 May 2011
Price 2	4.60	25 May 2011
Price 3	3.50	24 August 2011

Source: HSBC

Samsung Heavy Industries (010140.KS) Share Price performance KRW Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight (V)	Neutral	19 July 2010
Neutral	Overweight	19 November 2010
Overweight	Neutral	05 January 2011
Neutral	Underweight	23 May 2011
Underweight	Neutral	23 August 2011
Target Price	**Value**	**Date**
Price 1	36000.00	20 November 2009
Price 2	34000.00	16 March 2010
Price 3	26000.00	19 July 2010
Price 4	42000.00	19 November 2010
Price 5	41000.00	23 May 2011
Price 6	33000.00	23 August 2011

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA RONGSHENG HE	1101.HK	2.25	11-Jan-2012	4, 11
DAEWOO SHIPBUILDING & MARINE	042660.KS	24800.00	11-Jan-2012	5, 7
HYUNDAI HEAVY INDUSTRIES	009540.KS	288000.00	11-Jan-2012	7
SAMSUNG HEAVY INDUSTRIES	010140.KS	31200.00	11-Jan-2012	7

Source: HSBC

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