24 May 2018

HSBC Global Research

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Yangzijiang Shipbuilding (YZJSGD SP)

Downgrade to Reduce: Goodbye blue sky

EQUITIES
MACHINERY

Singapore

- The operating environment is set to get more difficult with new orders declining, costs increasing and competition intensifying
- Valuation of 0.7x 2019e PB is not cheap given that we expect YZJ's ROE to fall sharply from 12% in 2017 to 5.5% in 2020e
- Downgrade to Reduce from Buy as we cut 2018-19 net profit estimates by 20-32% and TP to SGD0.87 from SGD1.99

What's changed? New order outlook, steel prices, RMB vs USD, and competition

After a record USD2.1bn of new orders in 2017, we had expected order momentum to slow down in 2018 but not to the extent we are witnessing now. YZJ has won only USD0.27bn of new orders in 1Q18, and our shipping research team forecasts a bleak outlook for bulk carrier orders, which are the bread and butter for YZJ. The company does not build liquefied natural gas (LNG)/floating LNG (FLNG) carriers, a segment of the shipbuilding market we are bullish on.

In addition, steel prices have firmed up and are inching higher, while a strong RMB isn't helping YZJ's cause either (given YZJ's revenues are in USD and costs are in RMB). Also, competition for bulk carriers and containerships has increased from the Korean, Japanese and Chinese yards, which would affect the pricing of new vessels.

More downside risks – 67% of current order book not profitable

Of the 123 vessels YZJ had in its order book at the end of 2017, 83 are not profitable, according to the company's statement in 1Q18. Of these 83, the company has taken provisions on 63 vessels. Going forward, the company is booking 0% margin on 63 vessels, while 20 vessels still have downside risks, in our view.

Impact – Reduce new order estimates by 18-34%; lower margin estimates

We are reducing our new order estimates for 2018e from USD1.5bn to USD1.2bn, and for 2019e from USD1.4bn to USD0.9bn. We also lower our gross margin estimate for the shipbuilding segment from 19% in 2018-19e to 15% for 2018-20e, to account for higher steel prices (we expect steel prices to rise by 10% in 2018e and then stabilize in the next two years), a strong RMB (YZJ's revenues are in USD and costs are in RMB, thus stronger RMB hurts), steeper competition, and 0% margin on 63 vessels in the book.

Downgrade the stock to Reduce from Buy; too many risks and no catalysts

We are downgrading YZJ to Reduce from Buy as we cut our net profit estimates by 20-32% for 2018-19e and our DCF-based target price to SGD0.87 from SGD1.99. We also introduce 2020 estimates in this report. Our net profit estimates are now 19-26% below consensus for 2018-20e. Although the stock looks cheap at a 0.7x 2019e PB, its ROE is falling from 12% in 2017 to 5.5% by 2020e, which is why the PB-to-ROE ratio is at an expensive 1.1x versus a 0.8x mean. In ASEAN, we prefer Keppel Corp (Buy) in the shipyards space because of its diversified business model.

DOWNGRADE TO REDUCE

TARGET PRICE (SGD)	PREVIOUS TARGET (SGD)
0.87	**1.99**

SHARE PRICE (SGD)	UPSIDE/DOWNSIDE
1.05	**-17.1%**

(as of 22 May 2018)

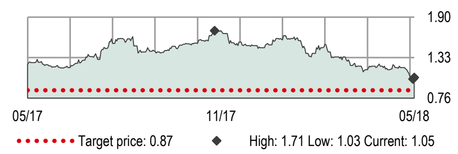
MARKET DATA

Market cap (SGDm)	5,484	Free float	46%
Market cap (USDm)	4,094	BBG	YZJSGD SP
3m ADTV (USDm)	16	RIC	YAZG.SI

FINANCIALS AND RATIOS (CNY)

Year to	12/2017a	12/2018e	12/2019e	12/2020e
HSBC EPS	0.77	0.48	0.43	0.41
HSBC EPS (prev)	0.67	0.58	0.60	-
Change (%)	14.9	-17.2	-28.3	-
Consensus EPS	0.64	0.60	0.60	0.61
PE (x)	6.5	10.4	11.7	12.2
Dividend yield (%)	4.4	3.8	3.4	3.3
EV/EBITDA (x)	6.4	7.4	7.8	7.9
ROE (%)	12.1	6.9	6.0	5.5

52-WEEK PRICE (SGD)



Source: Thomson Reuters IBES, HSBC estimates

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Financials & valuation: Yangzijiang Shipbuilding

Reduce

Financial statements

Year to	12/2017a	12/2018e	12/2019e	12/2020e
Profit & loss summary (CNYm)				
Revenue	19,206	16,458	15,493	14,540
EBITDA	3,185	2,749	2,485	2,372
Depreciation & amortisation	-483	-500	-500	-500
Operating profit/EBIT	2,703	2,249	1,985	1,872
Net interest	-113	35	37	56
PBT	3,488	2,434	2,172	2,078
HSBC PBT	3,488	2,434	2,172	2,078
Taxation	-395	-487	-434	-416
Net profit	2,932	1,835	1,637	1,566
HSBC net profit	2,932	1,835	1,637	1,566
Cash flow summary (CNYm)				
Cash flow from operations	-1,104	1,348	1,786	1,365
Capex	-48	-200	-200	-200
Cash flow from investment	1,156	-200	-200	-200
Dividends	-845	-734	-655	-627
Change in net debt	-536	-94	-931	-539
FCF equity	3,686	998	1,436	1,015
Balance sheet summary (CNYm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	9,515	9,215	8,915	8,615
Current assets	29,453	28,843	29,351	29,871
Cash & others	6,225	6,319	7,250	7,789
Total assets	43,373	42,463	42,671	42,891
Operating liabilities	11,044	9,241	8,367	7,551
Gross debt	4,891	4,891	4,891	4,891
Net debt	-1,334	-1,428	-2,359	-2,898
Shareholders' funds	25,885	26,986	27,968	28,908
Invested capital	21,699	22,498	22,649	23,146

Ratio, growth and per share analysis

Year to	12/2017a	12/2018e	12/2019e	12/2020e
Y-o-y % change				
Revenue	27.3	-14.3	-5.9	-6.2
EBITDA	23.7	-13.7	-9.6	-4.5
Operating profit	32.9	-16.8	-11.7	-5.7
PBT	25.8	-30.2	-10.8	-4.3
HSBC EPS	67.3	-37.4	-10.8	-4.3
Ratios (%)				
Revenue/IC (x)	1.0	0.7	0.7	0.6
ROIC	12.1	8.1	7.0	6.5
ROE	12.1	6.9	6.0	5.5
ROA	7.5	4.7	4.2	4.1
EBITDA margin	16.6	16.7	16.0	16.3
Operating profit margin	14.1	13.7	12.8	12.9
EBITDA/net interest (x)	28.1			
Net debt/equity	-5.2	-5.3	-8.4	-10.0
Net debt/EBITDA (x)	-0.4	-0.5	-0.9	-1.2
CF from operations/net debt				
Per share data (CNY)				
EPS Rep (diluted)	0.77	0.48	0.43	0.41
HSBC EPS (diluted)	0.77	0.48	0.43	0.41
DPS	0.22	0.19	0.17	0.16
Book value	6.75	7.04	7.30	7.54

Key forecast drivers

Year to	12/2017a	12/2018e	12/2019e	12/2020e
Order inflow (USD bn)	2.11	1.21	0.93	1.15
Order book (USD bn)	4.71	3.98	3.35	3.10
Average Steel Price (USD/tonne)	501	550	535	535

Valuation data

Year to	12/2017a	12/2018e	12/2019e	12/2020e
EV/sales	1.1	1.2	1.2	1.3
EV/EBITDA	6.4	7.4	7.8	7.9
EV/IC	0.9	0.9	0.9	0.8
PE*	6.5	10.4	11.7	12.2
PB	0.7	0.7	0.7	0.7
FCF yield (%)	17.0	4.6	6.6	4.7
Dividend yield (%)	4.4	3.8	3.4	3.3

* Based on HSBC EPS (diluted)

Issuer information

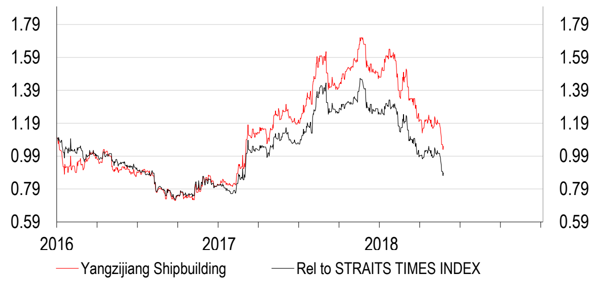
Share price (SGD)	1.05	Free float	46%
Target price (SGD)	0.87	Sector	Machinery
Reuters (Equity)	YAZG.SI	Country	Singapore
Bloomberg (Equity)	YZJSGD SP	Analyst	Somesh Agarwal
Market cap (USDm)	4,094	Contact	+65 6658 0616

ESG metrics

Environmental Indicators		Governance Indicators	
GHG Intensity (kg/USD)	[n/a]	No. of board members	4
Energy Intensity (kWh/USD)	[n/a]	Average board experience (years)	7.0
CO2 reduction policy	Yes	Female board members (%)	0.0%
Social Indicators		Board members Independence (%)	50.0%
Employee costs as % of sales	[n/a]		
Employee turnover (%)	[n/a]		
Diversity policy	Yes		

Source: Company data, HSBC

Price relative



Source: HSBC

Note: Priced at close of 22 May 2018

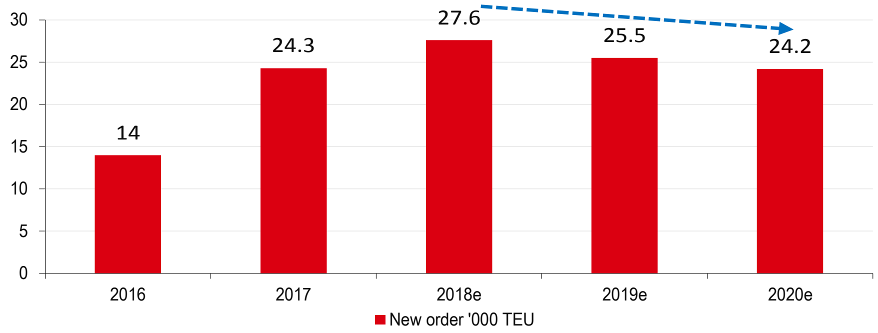
What's changed? New order outlook, steel prices, RMB vs USD and competition

Reducing our order inflow estimates by 18-34% for 2018-20e

Driven by our shipping team's weak outlook especially for bulk carriers, we have reduced our new order assumptions from USD1.5bn for 2018e to USD1.2bn, from USD1.4bn for 2019e to USD0.9bn, and from USD1.4bn for 2020e to USD1.2bn.

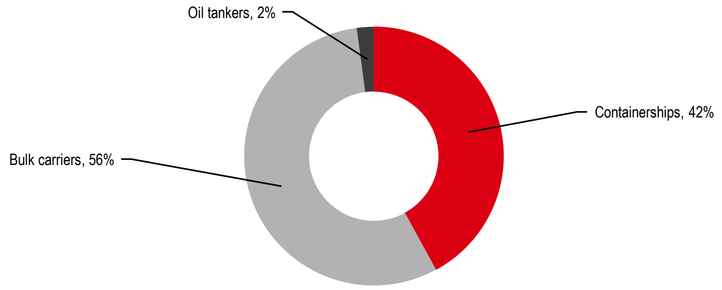
YZJ does not build LNG/FLNG vessels, a segment of the shipbuilding market that we as a house are bullish on (see *Global LNG: The glut abates, the crunch awaits*). Korean shipyards are the leaders in building LNG/FLNG vessels, while Singapore shipyards are second in line as they convert other vessels into FLNG (*Korea Shipbuilding: Full steam ahead*).

We expect global bulk carrier orders to peak in 2018e



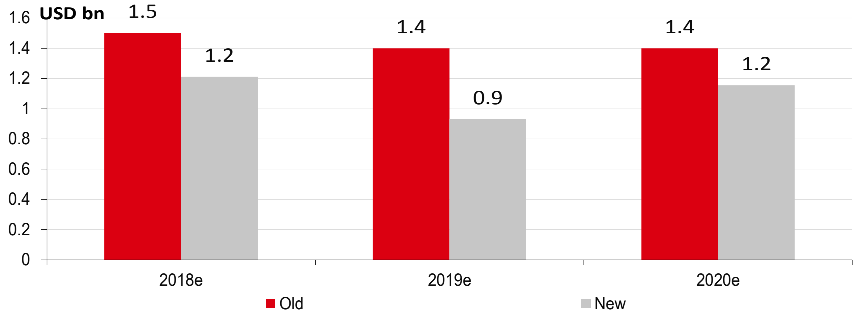
Source: HSBC estimates

Bulk carriers are bread and butter for YZJ – 56% of its end-2017 order book of USD4.7bn is from bulk carriers



Source: Company reports, HSBC estimates

We are thus reducing our order inflow estimates for YZJ significantly

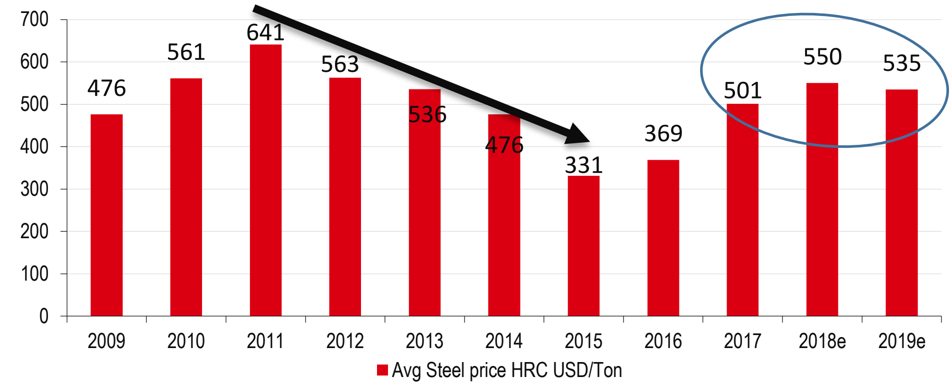


Source: HSBC estimates

Steel prices are not abating

Steel makes up c40% of the shipbuilding costs, and has been on an upward trajectory since 2015. Even in the last three months, steel prices have shot up to USD571/ton from USD501/ton at the end of 2017. Our in-house view is for stable steel prices in 2018 supported by supply reforms in China and a wave of protectionist measures by various countries.

China steel prices to remain high

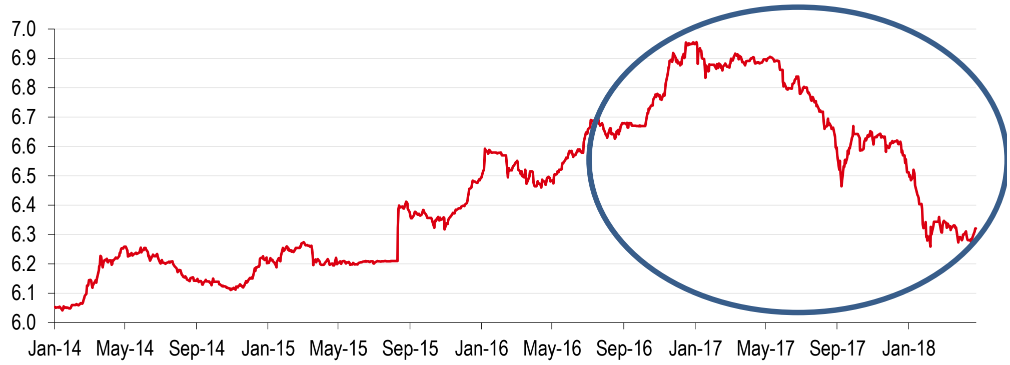


Source: CEIC, HSBC estimates

RMB/USD has gathered strength

A strong RMB is not helping YZJ's cause (given YZJ's revenues are in USD and costs are in RMB). The RMB has strengthened 10% vs the USD since the start of 2017, thus hurting the margins that YZJ makes on bulk carriers and containerships.

RMB has strengthened significantly against the USD in the last few quarters

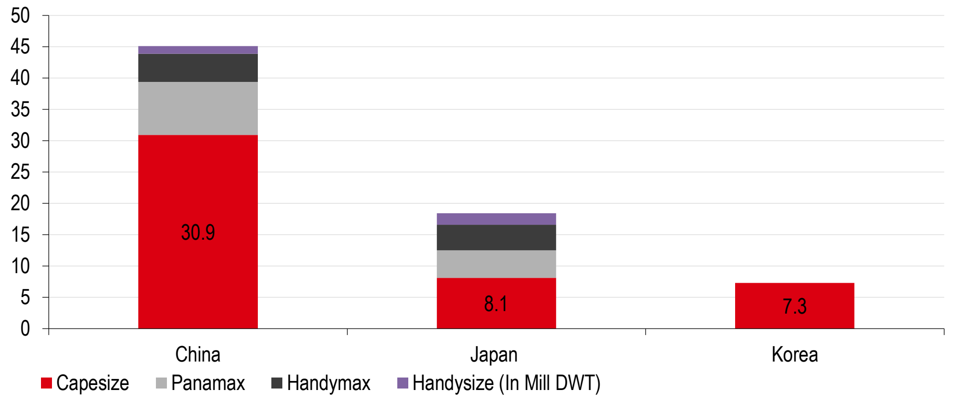


Source: Bloomberg

Competition from Korea and Japan, and even from within China has stepped up

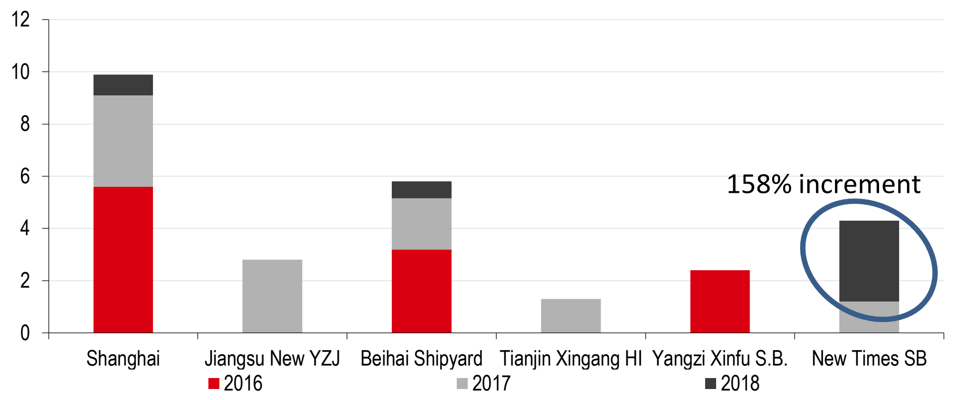
Bulk carriers are built in three major port countries namely China, South Korea and Japan that constitute for more than 85% of the total ship building orders. Competition from Korea and Japan has stepped up in the recent past, as their yards are much larger and are looking to fill up the space with shipbuilding orders even at the cost of undercutting prices. Even Chinese shipbuilders such as Shanghai Waigaoqiao, YZJ, Beihai Shipyard and New Times SB are getting more aggressive to win new bulk carrier and containership orders. New Times SB is aggressively growing its bulk carriers' order book, while Huangpu Wenchong is aggressively growing its containerships' order book (by 30% in 1Q18).

China is the market leader in bulk carriers with Korea specialising in Capesize vessels



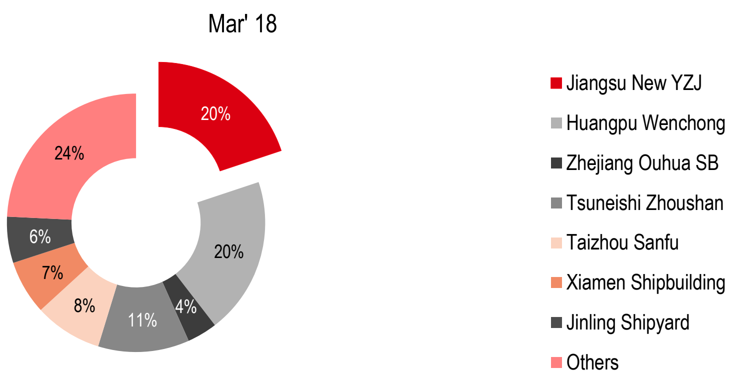
Source: Clarksons Research

New times Shipbuilding is aggressively increasing its bulk carriers' order book portfolio



Source: Clarksons Research

YZJ has been the leader in feeder containership orders but Wenchong has caught up



Source: Clarksons Research

Impact – Reducing net profit estimates and target price

Profit estimates lower on the back of lower order inflows and margin estimates

We have reduced our order inflow estimates, which affect our revenue estimates negatively. In addition, given 67% of the current order book is going to be booked at 0% gross margin and that we expect new orders to come in at lower margins, we have reduced our margin estimates significantly. Thus, our net profit estimates have come down by 20-32% for 2018-19e. We also introduce 2020 estimates in this report.

YZJ – Lowering net profit estimates by 20-32%

	2018e			2019e		
RMBm	New	Old	Difference	New	Old	Difference
Revenue	16,458	16,897	-3%	15,493	17,315	-11%
EBIT	2,249	3,041	-26%	1,985	3,117	-36%
EBIT margin	13.7%	18.0%	-4.3%	12.8%	18.0%	-5.2%
Net profit	**1,835**	**2,306**	**-20%**	**1,637**	**2,393**	**-32%**

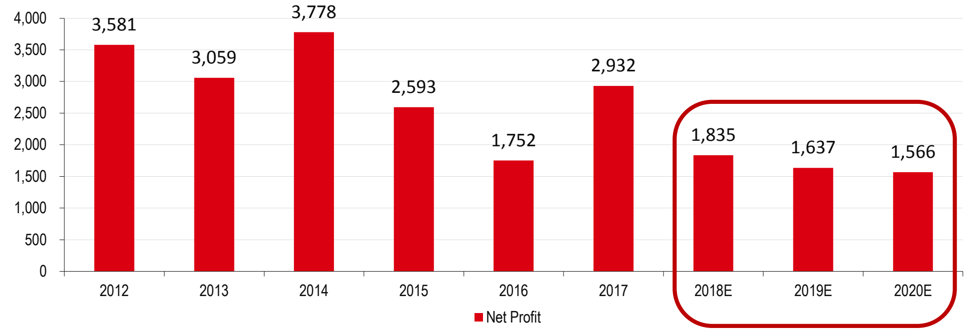
Source: HSBC estimates

Our net profit estimates are significantly below consensus now

RMBm	2018e	2019e	2020e
Consensus	2,275	2,227	2,107
HSBC	1,835	1,637	1,566
Difference	**-19%**	**-26%**	**-26%**

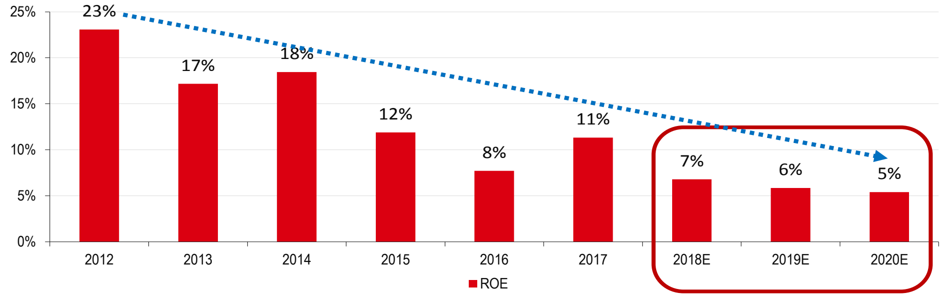
Source: Bloomberg, HSBC estimates

We expect profitability to decline to new lows over the next three years (RMBm)



Source: Company reports, HSBC estimates

We expect ROE to decline to its lowest level by 2020e



Source: Company reports, HSBC estimates

Our DCF-based target price comes down by 56% to SGD0.87

Given the significant impact of our order inflow cuts on our long-term cash flow projections, our DCF-based valuation comes down from SGD1.99 to SGD0.87. Given the 17% downside implied by our new target price, we downgrade the stock to Reduce from Buy as we believe there is significant downside risk from bulk carrier orders slowing down, and the stock price does not yet reflect the risk of impairment on the current order book.

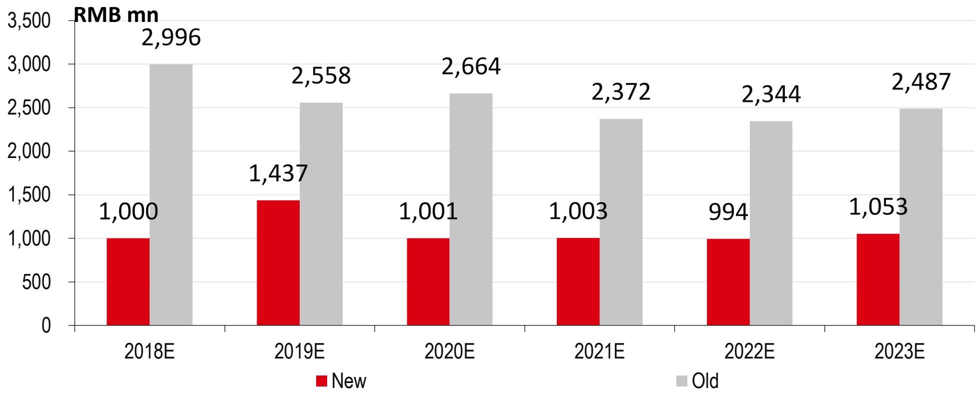
Our DCF assumptions are largely unchanged with an unchanged before tax cost of debt of 6.0%, and a slightly higher cost of equity of 8.6% vs 8.3% earlier as the beta (the average of last six months) has increased from 1.16x to 1.22x. Our WACC has thus marginally increased from 7.7% earlier to 8.0% now.

YZJ – DCF valuation of SGD0.87

RMBm	2018e	2019e	2020e	2021e	2022e	2023e	Perpetuity
FCF	**1,000**	**1,437**	**1,001**	**1,003**	**994**	**1,053**	**17,858**
Sum of PV of FCF	15,673						
Add: Cash	6,319						
EV	**21,991**						
Less: Debt	4,891						
Less: Minority Interest	744						
Equity Value	**16,357**						
No. of shares	3832.2						
Equity value per share (RMB)	**4.27**						
SGD / RMB exchange rate	4.90						
Equity value per share (SGD)	**0.87**						
Growth rate in perpetuity	2.0%						
WACC	**8.0%**						
Beta	1.2						
Risk Free Rate	2.5%						
Equity Risk Premium	5.0%						
Cost of Equity	**8.6%**						
Before tax cost of debt	6.0%						
Tax rate	20.0%						
Cost of Debt	**4.8%**						

Source: HSBC estimates

Changes in FCF from our previous estimates



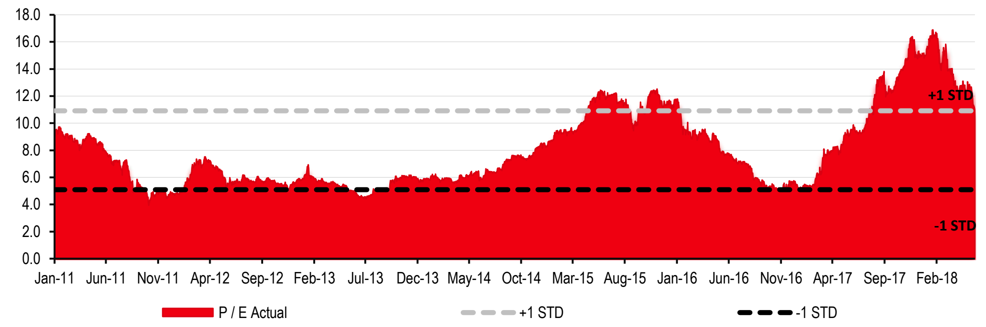
Source: HSBC estimates

Valuations – Prudent to look at PB to ROE, given the ROE profile

On PE, the stock is trading at +1SD level above mean

Our new TP implies a 2019e PE of 10x, which compares to a mean of 8.0x since 2011, slightly below +1SD level of 10.9x. The stock is currently trading at an 11x one-year forward PE, almost at +1SD level of 10.9x.

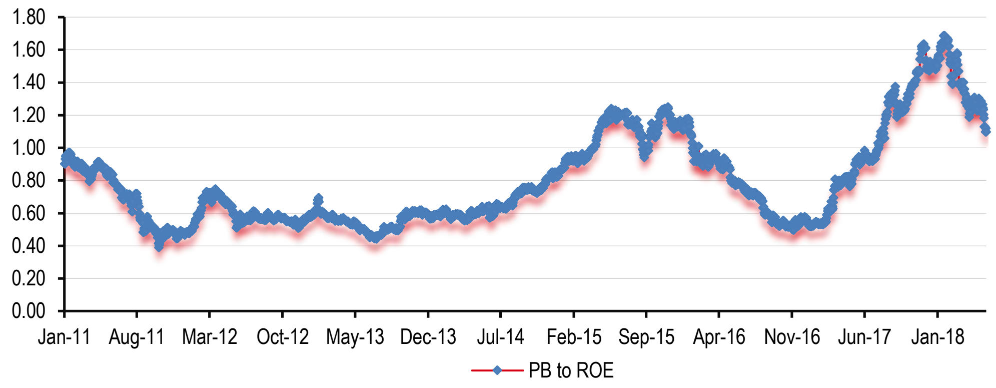
On PE, the stock is trading at +1SD level above mean since 2011



Source: Bloomberg, HSBC estimates

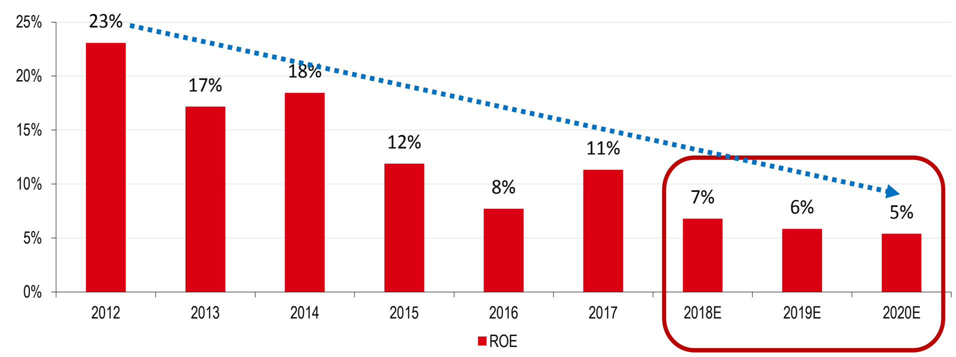
On PB, the stock looks cheap, but on PB to ROE, it looks very expensive
Our new TP implies a 2019e PB of 0.6x, which compares to a mean of 1.0x since 2011 and close to -1SD level of 0.65x. While the stock looks cheap on PB, it is important to note that the ROE profile of the company is deteriorating sharply. Thus, it is prudent to look at the PB to ROE ratio rather than absolute PB, in our view. On PB to ROE, the stock is trading at 1.1x, much higher than the mean of 0.8x since 2011. This is why we think the stock is expensive.

On PB to ROE, the stock looks very expensive



Source: Bloomberg, HSBC estimates

The ROE profile is deteriorating sharply



Source: Company reports, HSBC estimates

YZJ's valuation versus its peers

In the table below, we list the shipyards in Singapore and Malaysia that are peers for YZJ.

On PE, the stock looks cheaper than Keppel Corp or Sembcorp Marine, but it has a much worse earnings profile over 2016-19e. On PB, the stock looks as cheap as Bumi Armada but we believe Bumi Armada's ROEs will be going up to double-digits by 2019e, while YZJ's ROE is coming down to 6% by 2019e.

YZJ also is the only shipyard under our coverage that has the PB to ROE ratio increasing from 2018e to 2019e, given that it is the only shipyard under our coverage whose ROEs are declining while PB remains the same.

Valuation table – YZJ's peers in Singapore and Malaysia

Company	Bloomberg	HSBC	Current	Target		Market Cap	P/E		P/B		PB to ROE		ROE		EPS growth
Name	Ticker	Rating	Price	Price	Upside	USD bn	2018e	2019e	2018e	2019e	2018e	2019e	2018e	2019e	16-19e
Keppel Corp	KEP SP	Buy	8.21	9.28	13%	11.2	14.9	14.0	1.2	1.2	1.5	1.4	8%	8%	11%
Bumi Armada	BAB MK	Buy	0.82	0.87	6%	1.2	10.6	7.9	0.8	0.7	1.1	0.8	8%	10%	32%
Yangzijiang Shipbuilding	YZJSGD SP	Reduce	1.05	0.87	-17%	3.0	10.4	11.7	0.7	0.7	1.1	1.2	7%	6%	-2%
Sembcorp Marine	SMM SP	Hold	2.28	1.87	-18%	3.6	53.4	38.4	1.9	1.8	5.3	3.8	4%	5%	16%
SembCorp Industries	SCI SP	Hold	3.06	3.05	0%	4.1	13.6	11.5	0.8	0.7	1.4	1.1	6%	6%	7%

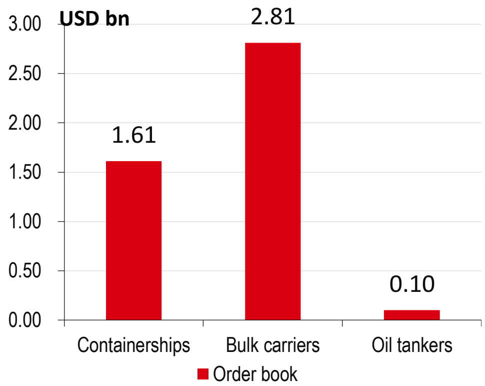
Source: Company reports, Bloomberg, HSBC estimates. Note: Current price as of end of 22 May 2018

Current order book holds a lot of downside risks

Of the 123 vessels YZJ had in its order book at the end of 2017, 83 are not profitable according to the company's statement in 1Q18. Of these 83, the company has taken provisions on 63 vessels. Going forward, the company is booking 0% margin on 63 vessels while 20 vessels still have downside risks, in our view.

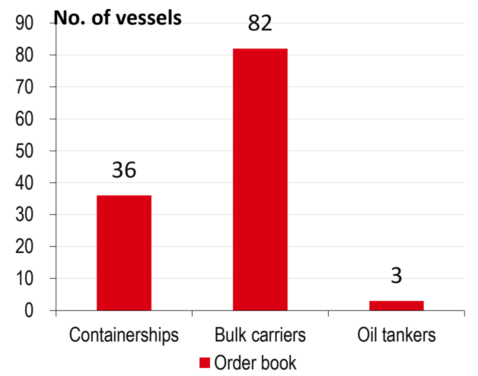
Also, looking at the two charts below, the end-1Q18 order books indicate that YZJ is heavily dependent on the bulk carriers segment. In terms of number of vessels, 68% of YZJ's current order book comes from bulk carriers, and in terms of value, 62% of YZJ's current order book comes from bulk carriers.

Most of the order book include bulk carriers as of end-1Q18 order book of USD4.52bn



Source: Company reports

82 of the 121 vessels in order book as of end-1Q18 are bulk carriers



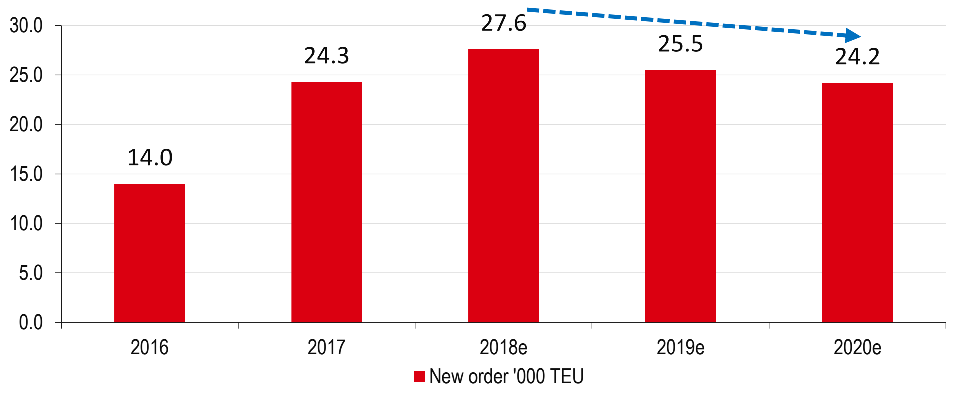
Source: Company reports

Bulk carriers – New orders to decline from 2019e

New orders to start declining from 2019e; Baltic Dry Index is the leading indicator

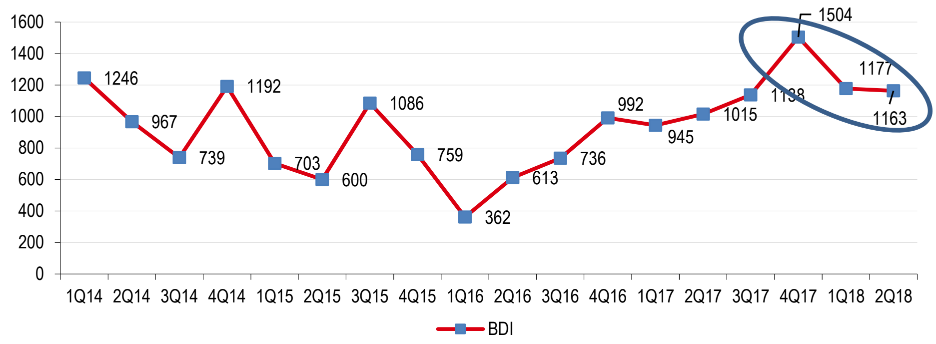
Our shipping team forecasts that the bulk carrier orders will grow by 13% in 2018e before starting to decline from 2019e. While we expect bulk trade to grow at 3.3% CAGR over 2018-20e, we do not expect it to translate into new bulk carrier orders globally as we think that the second-hand vessels market will be more favoured than the new build market. There is also a great deal of uncertainty over the new emission laws that will affect new bulk carriers ordering, in our view.

We expect bulk carrier orders to start declining from 2019e



Source: Clarksons Research, HSBC estimates

Baltic Dry Index has started reversing after touching a high in 4Q17



Source: Thomson Reuters Datastream

Dry Bulk Carriers: Fundamentals

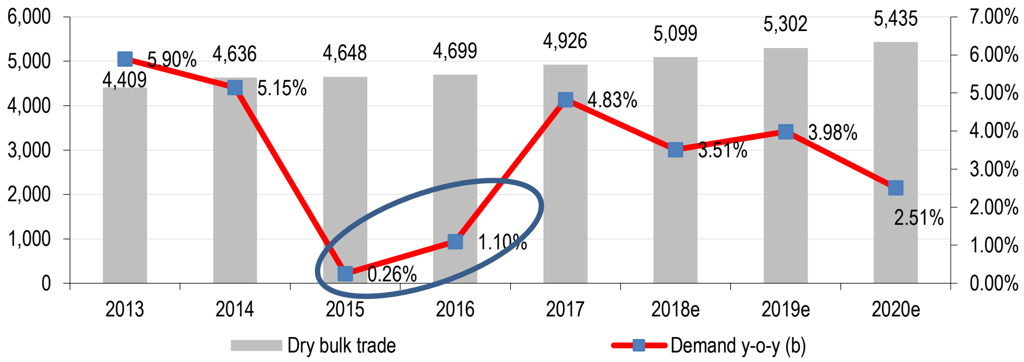
'000 TEU	2013	2014	2015	2016	2017	2018e	2019e	2020e
New order	103.2	63.9	25	14	24.3	27.6	25.5	24.2
y-o-y	324.30%	-38.08%	-60.88%	-44.00%	73.57%	13.58%	-7.61%	-5.10%
Delivery	62.9	48.4	49.2	47.2	38.2	34.3	25.3	10.5
y-o-y	37.30%	-23.05%	1.65%	-4.07%	-19.07%	-10.21%	-26.24%	-58.50%
Backlog	139.9	171.4	147	114	100	93	94	107
y-o-y	39.90%	22.52%	-14.24%	-22.45%	-12.28%	-7.00%	1.08%	13.83%
Demolition	23.1	16.4	30.7	29.3	14.2	14	14	14
y-o-y	30.80%	-29.00%	87.20%	-4.56%	-51.54%	-1.41%	0.00%	0.00%
Fleet (EOY)	726	758	776	794	818	839	850	846
Supply y-o-y (a)	5.70%	4.41%	2.37%	2.32%	3.02%	2.57%	1.31%	-0.40%
Dry bulk trade	4,409	4,636	4,648	4,699	4,926	5,099	5,302	5,435
Demand y-o-y (b)	5.90%	5.15%	0.26%	1.10%	4.83%	3.51%	3.98%	2.51%
Demand(b) - Supply(a)	0.2ppt	0.8ppt	-2.2ppt	1.2ppt	1.8ppt	1.0ppt	2.7ppt	2.9ppt

Source: Clarksons Research, HSBC estimates

Dry bulk demand to continue growing

We expect dry bulk demand to continue growing mainly due to increased consumption and better-than-expected seaborne iron ore and coking coal trade growth for China.

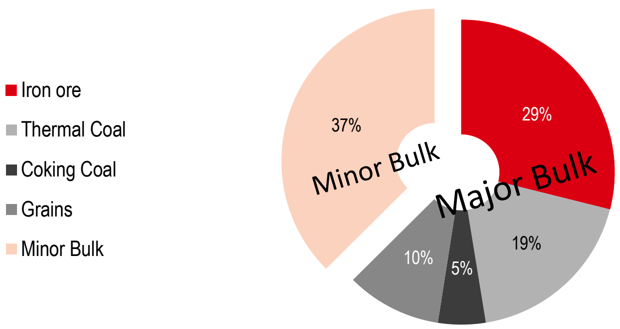
Dry bulk demand to continue growing



Source: Clarksons Research, HSBC estimates

Breaking down where the 'dry bulk demand' comes from
The dry bulk trade can be divided into major bulk and minor bulk. Relatively low value (per tonne) commodities like iron ore, coal and grains account for more than two-third of the total seaborne bulk trade and are grouped under major bulk. Products that are relatively expensive (per tonne) like steel products, aluminium, cement, sugar and fertilisers are termed as minor bulk.

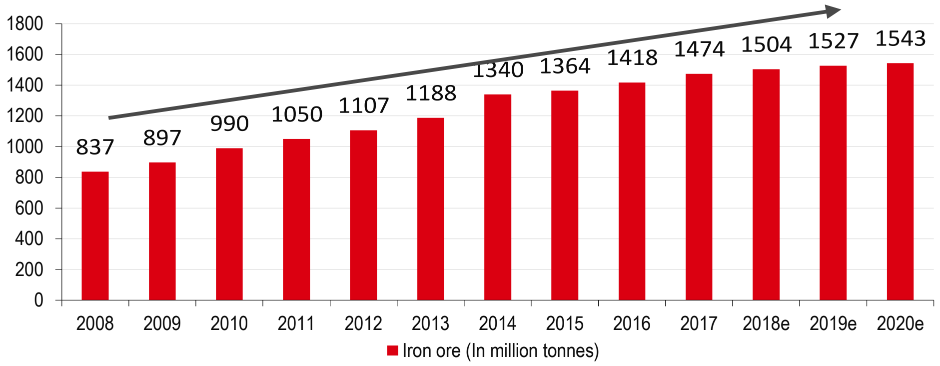
Proportion of bulk trade in 2017



Source: Clarksons Research

- **Iron ore trade:** Iron ore trade grew by 4% in 2017 and has grown at a five-year CAGR (for 2012-17) of 6%. According to our in-house estimates, the seaborne trade should grow at a CAGR of 2% through 2018-20e driven by the recovery of demand in steel globally and increased iron ore imports by China due to a shift towards higher-grade, imported iron ore and easing domestic iron ore production.

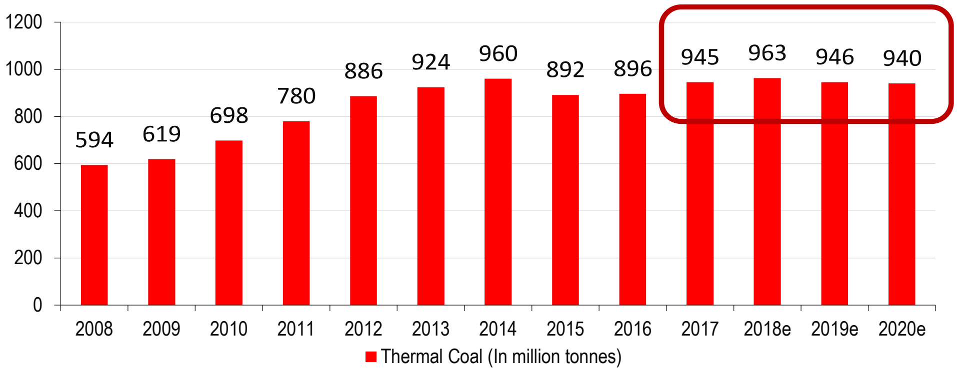
Iron ore seaborne trade to grow marginally from 2018-20e



Source: Clarksons Research, HSBC estimates

- **Thermal coal trade:** Thermal/steam coal trade increased by 5% y-o-y in 2017, and we estimate the trade to continue to increase in 2018 by 2%. However, we estimate a flat trade thereafter as gas usage increasingly continues to displace coal-fired power generation in regions like the EU with renewable power generation.

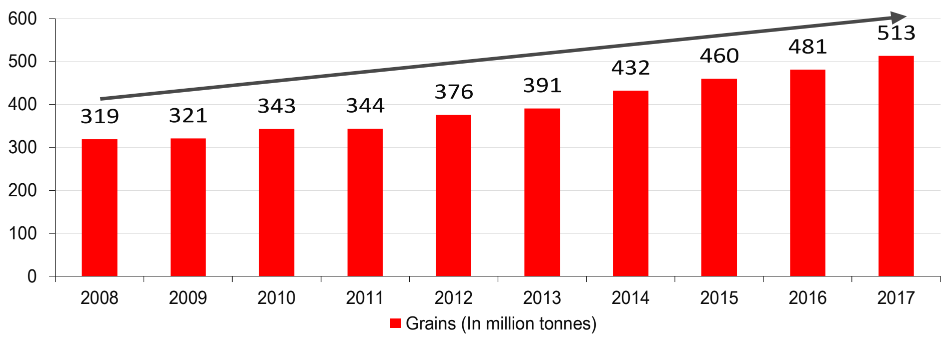
Thermal coal trade to be stable



Source: Clarksons Research, HSBC estimates

- **Grain imports:** Grains like wheat and soybean continue to dominate the bulk trade growth, with 7% growth in 2017 and a five-year CAGR (2012-17) of 6%. The Middle East is the major importer of foodgrains with Saudi Arabia as the largest importer country. Overall, we expect global wheat and coarse grain trade to grow in the future, with a majority of countries holding low levels of inventories currently.

Grain imports grew by 7% in 2017

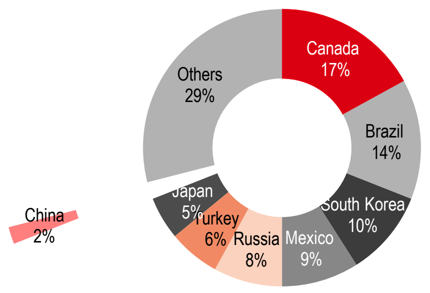


Source: Clarksons Research

Why the US-China trade war will have no effect on bulk trade?

China contributes very little to the steel (2%) and aluminium (9%) imports of the US. On 8 March 2018, President Trump signed a tariff order on metals, with a 25% steel import tariff, effective in 15 days, designed to combat the c30-35mt of US steel imports and help the US steel industry increase its utilization rate to 80%. Most of the major exporters of these commodities like Canada (16%) and Mexico (9%) to the US have already availed exemptions and so the tariffs by the US will have little impact on dry bulk trade, in our view.

China is a minority exporter of steel to the US

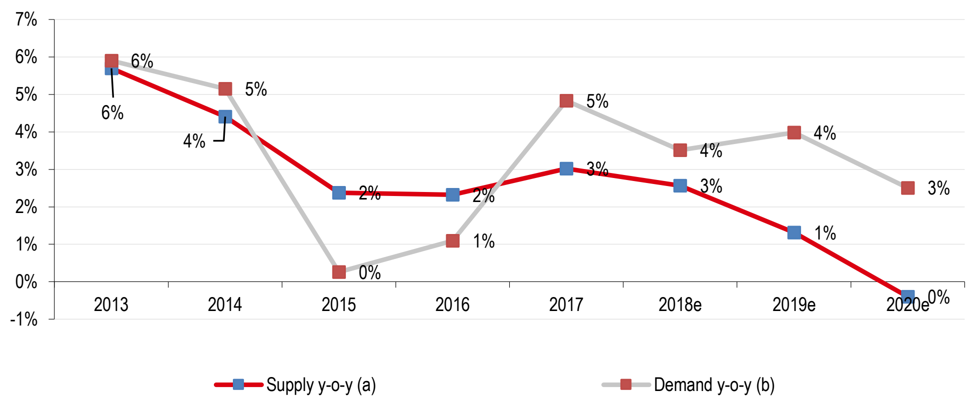


Source: Department of Commerce

On the same date, President Donald Trump also signed presidential actions to impose tariff of 10% on aluminium imports. The US granted exemption from these tariffs to Canada and Mexico, conditional on ongoing NAFTA negotiations. Subsequently on 22 March, the US President suspended tariffs on aluminium imports from Argentina, Australia, Brazil, South Korea and the 28 nations of the EU until 1 May 2018. As can be seen, tariffs and restrictions should not significantly affect the bulk trade.

<u>Dry bulk supply</u>: How well is supply meeting the bulk trade demand requirements?
Even as we expect demand for bulk trade to increase by 3-4% over the next three years, we expect new order growth to slow down.

Demand to outpace supply

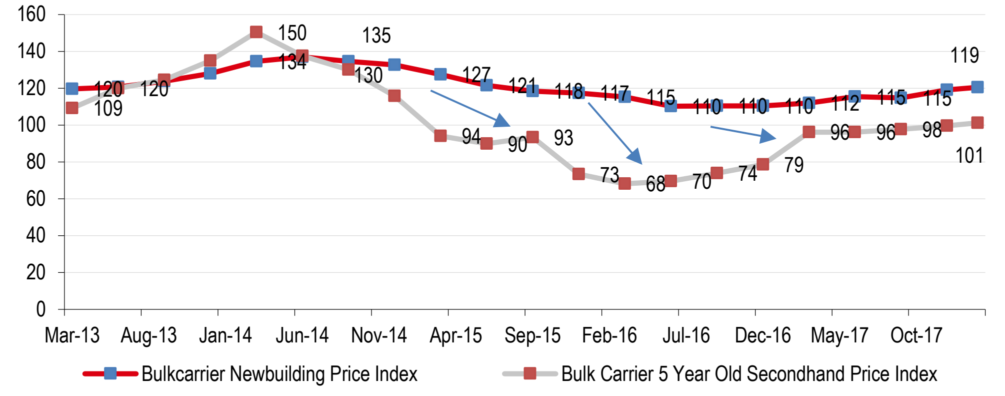


Source: Clarksons Research, HSBC estimates

Why do we expect low newbuild orders despite increase in dry bulk demand?

- **Environmental regulations:** The key reason for the expected decline in the new orders is the uncertainty in the shipbuilding industry due to environmental regulations like SOX regulations and ballast water treatment technology for which shipping companies are adopting a wait-and-see attitude. This has been discussed at length in the containership section.
- **Attractive second-hand ship market:** Another significant reason for the passive growth in new ship orders is attractive second-hand ship prices. Second-hand price index fell by about 16% CAGR in 2013-16, which can also be corroborated with the slump in new orders in 2016 when it touched a historical low. However, the index has picked up slightly from there onwards but we expect the second-hand prices to still be considerably lower than new build prices, thus serving shipping owners with an attractive alternative.

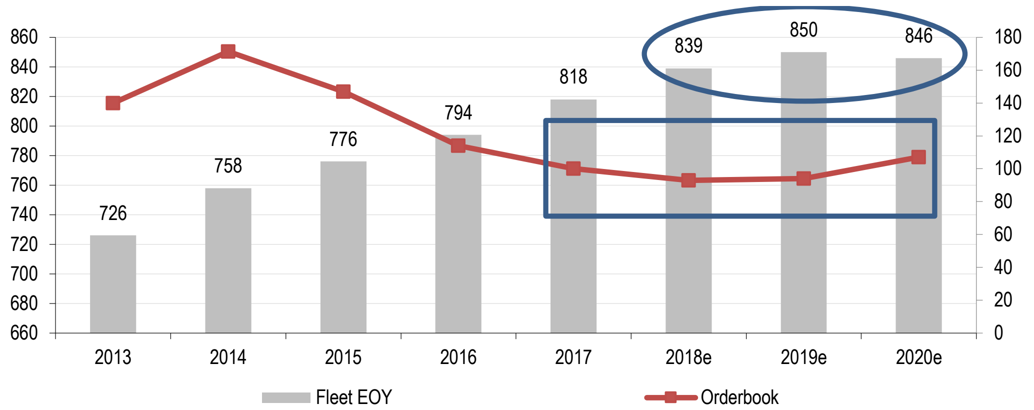
Second-hand prices have a significant gap versus newbuilds – hence making them attractive



Source: Clarksons Research

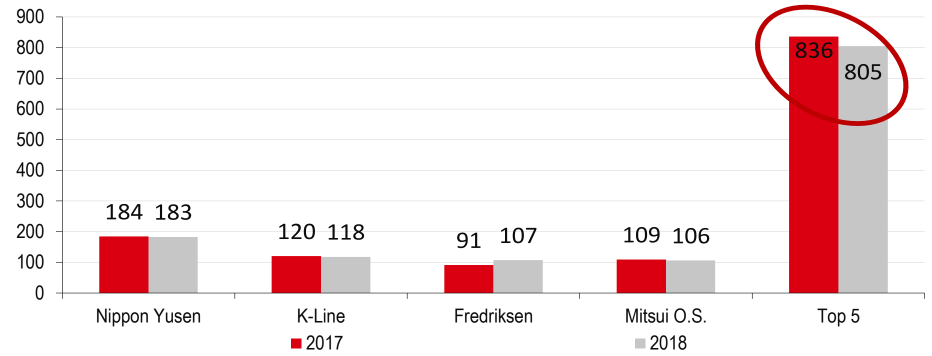
- **Major bulk carriers are adopting the wait-and-see attitude:** Order books for bulk shipbuilders are significantly below 2010-11 levels and declined further by 13% in 2017. With increased regulation and better second-hand vessel prices, we expect new order stagnancy to continue. Major bulk shipping companies have been passive in increasing their fleet in 2017.

We do not expect bulk shipbuilders order book / fleet to grow in 2018-20e



Source: Clarksons Research

Total fleet for top 5 shipping companies on a decline



Source: Clarksons Research

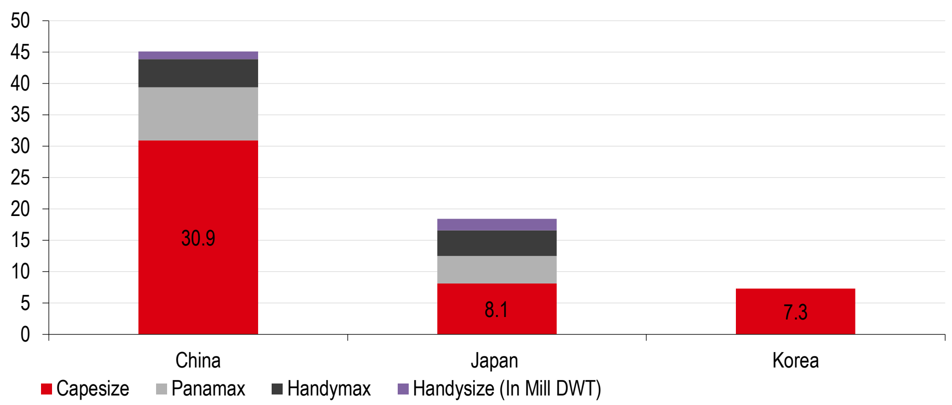
<u>Competitive environment</u> – getting more intense

Bulk carriers are built in three major port countries namely China, South Korea and Japan, which constitute more than 85% of the total ship building orders. Japan was the first entrant starting as early as the 1960s, followed by Korea in the 1980s and then China in the 1990s with the former two (Japan and Korea) known for their cutting-edge technology and China known for its cost efficiency due to cheap labour.

China shipbuilders amount for more than 60% of the total bulk carrier orders. All the domestic/ captive Chinese demands are met by Chinese portbuilders as majority of the shipping companies in China are state controlled and hence have to place their orders through Chinese shipbuilders. Even for foreign shipping companies, China appears to be an attractive avenue as two major lending banks, Export-Import Bank of China (Cexim) and the China Development Bank, have aggressively supported Chinese shipbuilders by lending money in the form of buyer's credits and loan guarantees to support foreign shipowners ordering ships at the Chinese shipyards.

Among the Chinese shipbuilders, Shanghai Waigaoqiao, YZJ, Beihai Shipyard and New Times SB are the biggest in terms of order book size as of Feb 2018. With YZJ order book being dominated by Capesize and Panamax, we have evaluated the competition it faces in these segments.

China is the market leader with Korea only specialising in Capesize vessels



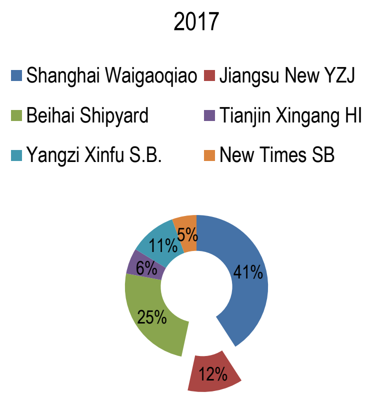
Source: Clarksons Research

Within China, competition is heating up

The dry bulk carrier market is dominated by six Chinese shipbuilders, of which Shanghai Waigaoqiao is the largest with a 41% market share in 2017. YZJ had a 12% market share in 2017, which we expect to decline to 10% in 2018.

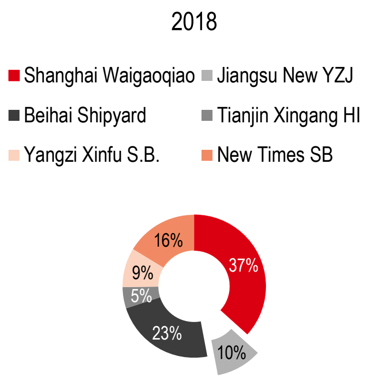
In 2018 YTD, Shanghai Waigaoqiao, Beihai and New Times SB have each bagged higher orders than YZJ amounting to 0.8, 0.65 and 3.1m DWT, respectively, increasing their market share further.

YZJ had a 12% market share in China bulk carriers market in 2017



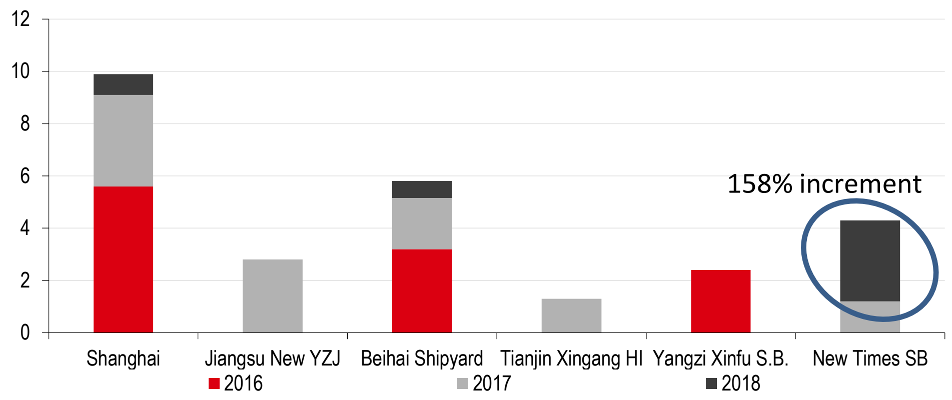
Source: Clarksons Research

We expect the market share to fall in 2018e



Source: Clarksons Research, HSBC estimates

Shipyards like New Times SB gains are gaining market share



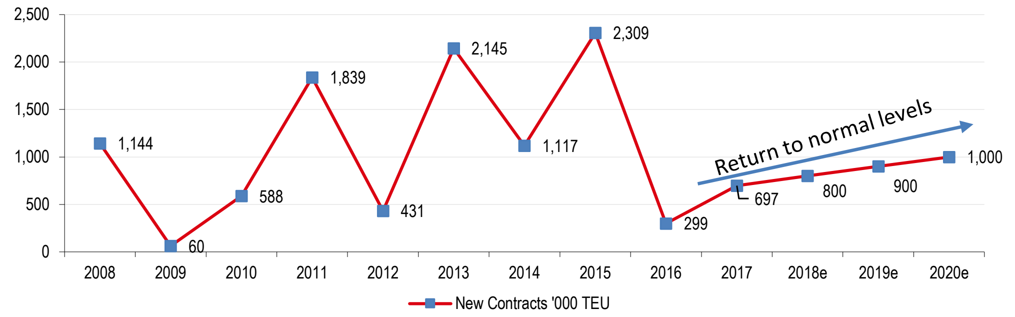
Source: Clarksons Research, HSBC estimates

Containerships – We expect stable growth but more competition

New orders to grow by a 13% CAGR over 2018-20e

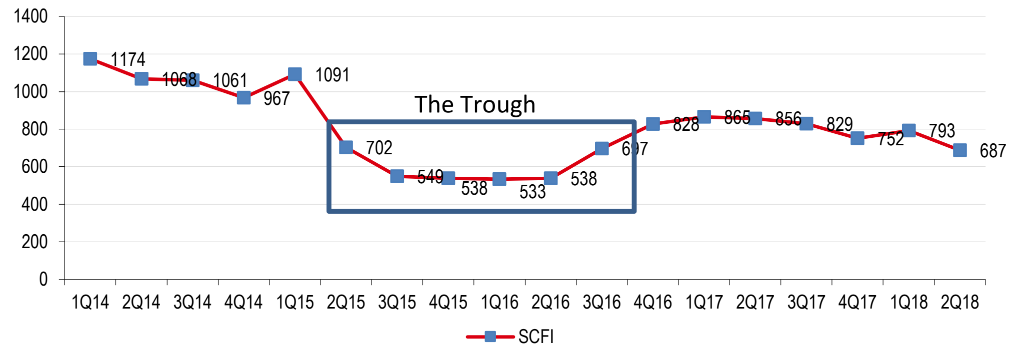
Unlike the bulk carriers market, we expect steady growth of 13% CAGR in newbuild containership demand from 2018-20e, driven by growth in Chinese exports and imports, and higher fuel and commodity prices. **The Shanghai Container Freight Index (SCFI)**, which is an important indicator for the health of containership trade, is however trending lower.

Containership: New orders to see stable growth



Source: Clarksons Research, HSBC estimates

SCFI is trending lower in the last nine months



Source: Thomson Reuters Datastream

Containership: Fundamentals

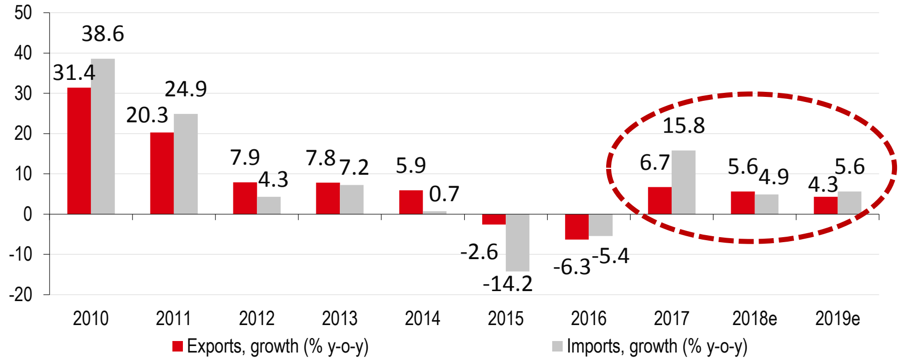
Containers (k TEU)	2015	2016	2017	2018e	2019e	2020e
New order	2,309	299	697	800	900	1,000
y-o-y	105.00%	-87.05%	133.11%	14.78%	12.50%	11.11%
Delivery	1,658	906	1,147	1,245	571	942
y-o-y	12.60%	-45.36%	26.60%	8.54%	-54.14%	64.97%
Backlog	3,967	3,280	2,781	2,300	2,613	2,663
y-o-y	-13.40%	-17.32%	-15.21%	-17.30%	13.61%	1.91%
Demolition	193	654	397	355	346	348
y-o-y	48.10%	238.86%	-39.30%	-10.58%	-2.54%	0.58%
Fleet (EOY)	19,085	19,938	20,435	21,254	21,811	22,221
Supply y-o-y	6.50%	4.47%	2.49%	4.01%	2.62%	1.88%
Total trade (kTEU)	175,006	182,104	191,549	199,565	208,457	217,764
Demand y-o-y	2.00%	4.06%	5.19%	4.18%	4.46%	4.46%
Demand(b) - Supply(a)	-4.5ppt	-0.41ppt	2.69ppt	0.18ppt	1.8ppt	2.58ppt

Source: Clarksons Research, HSBC estimates

Demand growth to come from Chinese exports and imports

The containership trade has grown at a healthy pace of 5% in 2017, and we expect it to grow at a CAGR of 4% in 2018-20e. Chinese imports and exports increased strongly with a growth rate of 15.8% and 6.7%, respectively, in 2017, after falling in 2015-16 due to poor business confidence following four years of steady weakening in growth and inflation. With growth in exports and imports picking up in 2017, our economics team expects 5.6% growth in exports and 4.9% growth in imports in 2018 driven by resilient demand for high-tech products from China and improving Chinese economic conditions.

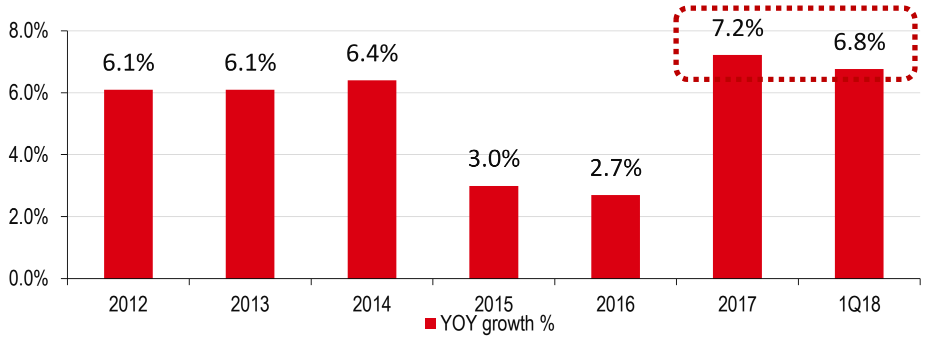
China: Growing imports and exports



Source: CEIC, HSBC Economic forecasts

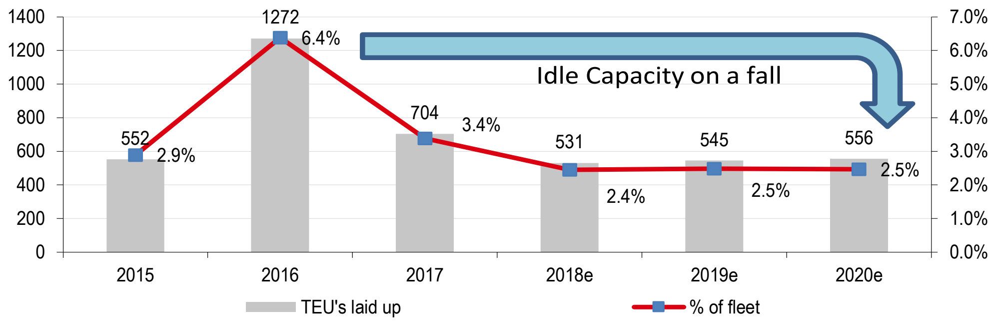
- **Container throughput increasing on the back of higher demand:** With an increase in demand in containership trade, it is only reasonable to expect ports' container throughput to increase globally. The top 8 ports for containership trade in China grew by 7.2% in 2017 and another 6.8% in 1Q18. The increase in containership trade has led shipping companies to fully utilise their fleet, thereby leading to a continuous decline in idle capacity from 6.4% of idle fleet in 2016 to 3.4% in 2017; we expect it to stay at c2.5% in 2018-20e.

Top 8 Chinese port container throughput growth at historical levels



Source: CEIC

Idle capacity as a % of fleet to decline as a result of stimulus in containership trade



Source: Clarksons Research, HSBC estimates

Downside risk to new order growth – regulatory issues and second-hand market
We think there is downside risk to our 11-15% new order growth projections for the 'containerships' market for the next three years. Industry leader Maersk Line and #5 player Hapag Lloyd have already declared that they will avoid investments in new builds and maintain capex discipline. The reasons for downside risk are two-fold:

1) **Regulatory issues:** Two new regulations – the cap on sulphur levels in fuel and ballast water treatment systems – are likely to have a significant financial impact on the industry. The International Maritime Organisation (IMO) has suggested that 1 January 2020 will be the implementation date and in recent meetings it further reinforced the message that "there is no turning back". But in our view, this target date is by no means certain and implementation could be deferred to as late as 2025.

The current global limit for sulphur content of ships' fuel oil is 3.50% mass by mass (m/m). The new global limit will be 0.50% m/m, which is a significant decline. This demand can be met by using approved methods, such as exhaust gas cleaning systems or "scrubbers", which "clean" the emissions before they are released into the atmosphere. Building of ships with these required setups is still at its nascent stages and shipowners are still adopting the wait-and-see attitude to decide how best this regulation can be met.

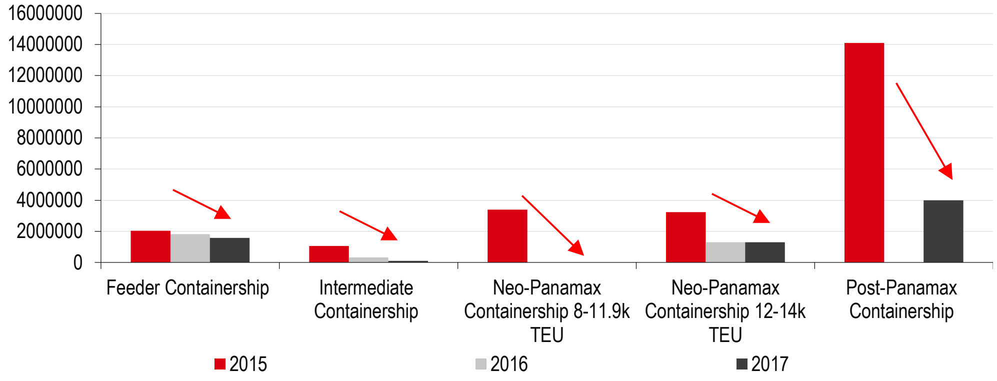
Ballast water management convention came into force on 8 September 2017 to tackle the threat to the marine ecosystem caused by bio-invasion. Ballast is placed in a ship filled with water to maintain balance and stability of a ship. It requires filling ballast with water at one place and emptying at another to maintain equilibrium. This move in and move out of water at different geographies bring in alien species to the marine eco-system, thereby threatening the habitat of marine liveforms. To tackle this problem, IMO has set rules and regulations regarding ballast water management, which involves shipping operators to implement ballast water treatment plants. However, constraints such as availability of space, cost of implementation, and level of environmental friendliness play an important role in the usage of a particular type of ballast water treatment system. This has caused many shipping operators to stall their purchases and some are looking out for ballast-free ships to mitigate the problems.

2) **Second-hand ship prices at attractive rates:** Clarksons Research's vessel pricing trend shows the second-hand ships are available at a discount due to Sox (Sulphur regulations) that will be applicable from 2020. The second-hand vessel prices have drastically fallen, widening the gap with newbuild prices and thereby presenting as an attractive alternative to new orders.

Competitive landscape – Intense competition in YZJ's bread and butter vessel class

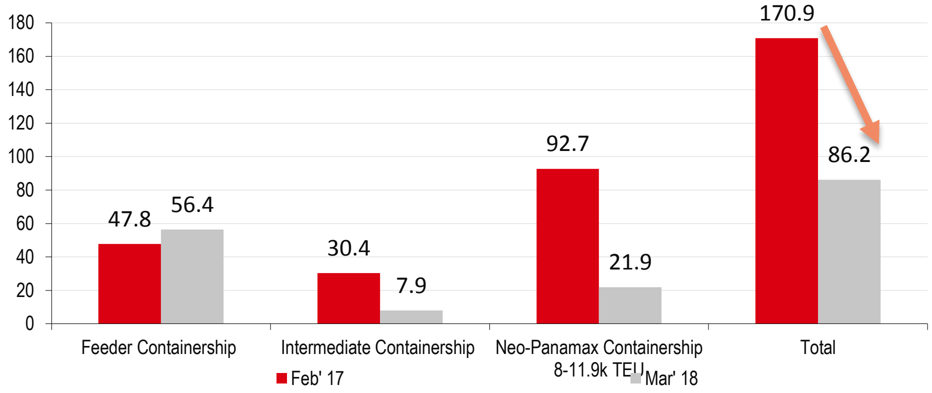
- **YZJ's key segments – Neo-Panamax and intermediate containerships are seeing a sharp fall in demand:** If we break down the containership market into five categories, the Neo-Panamax category (8-12k TEU capacity) has witnessed zero orders in the last two years after 3.3m TEU of orders in 2015. Even the Intermediate Containership segment saw orders dropping by almost 90% from 2015 levels over the next two years. In the Neo-Panamax category, there were only two new contracts in 2017, both awarded to Chinese yards.
- **Feeder containership segment has been the saviour for YZJ recently**: YZJ's containership order book in Mar 2018 fell by 50% from Feb 2017 levels, led by more than 70% fall in both intermediate containerships and Neo-Panamax containerships. However, feeder containership orders have grown, driven by orders from within China.
- **Competition intensifying in the feeder containership segment:** YZJ is one of the top two players in terms of feeder containership orders within China. However, competition is stepping up with Huangpu Wenchong, having increased its order book by 30% in 1Q18 and raised its market share from 17% to 20%. With feeder containership as the only segment poised to grow, YZJ has to aggressively price its vessels in order to keep its market share.

Intermediate containerships and Neo-Panamax segments saw significant declines in the last two years (order book in TEU)



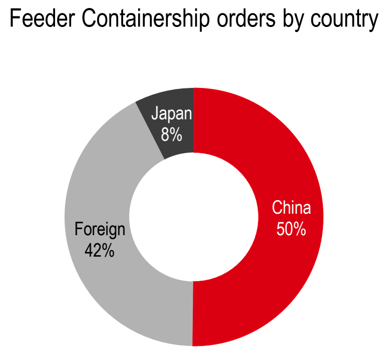
Source: Clarksons Research

YZJ containership order book in 000' TEU



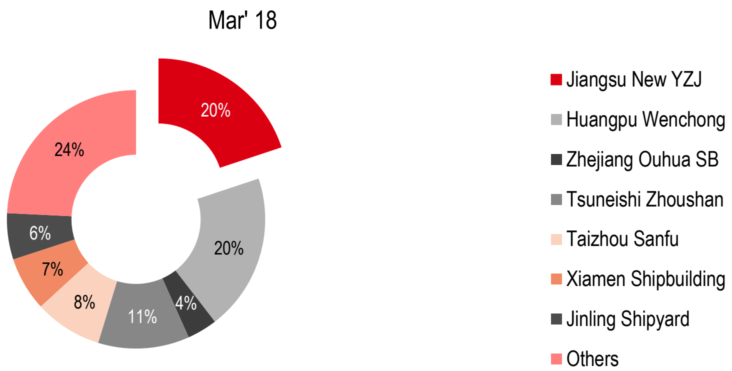
Source: Clarksons Research

Chinese companies place majority of the orders for feeder containership newbuilds



Source: Clarksons Research

YZJ is one of the top two players in feeder containership orders in China



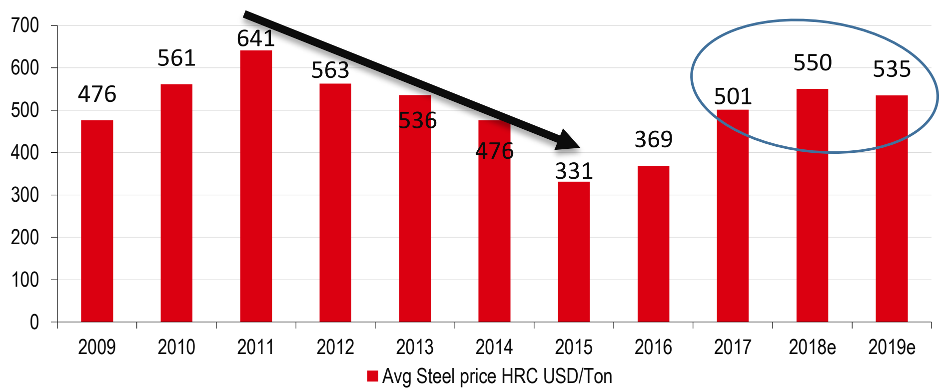
Source: Clarksons Research

Steel prices – Stable outlook due to strong supply control

After bottoming out in 2015, Chinese steel prices are on a path to stabilisation
Steel prices have been on a steady increase since 2015, spiking as much as 36% in 2017 to USD501/ton levels. It has maintained the average USD571/ton levels in 1Q18, mainly backed by the revival of steel production in China, after a four-month-long winter ban to curb air pollution which came to an end on 15 March.

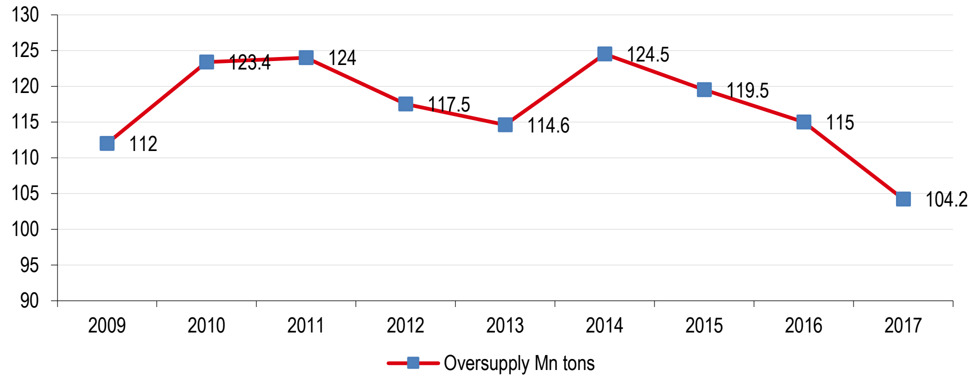
However, with the winter cuts coming to an end, we do expect the tightness to ease and prices to normalise to USD530/ton levels. Our in-house view is that stable steel prices in 2018 should be supported by supply reforms in China and a wave of protectionist measures by various countries. The oversupply gap has hence been on a steady decline since 2015 (see *Metals Quarterly Q2 2018: Trick of the trade wars*, 18 April 2018).

China Steel prices have been steadily rising since 2016



Source: CEIC, HSBC estimates

Oversupply gap filling up



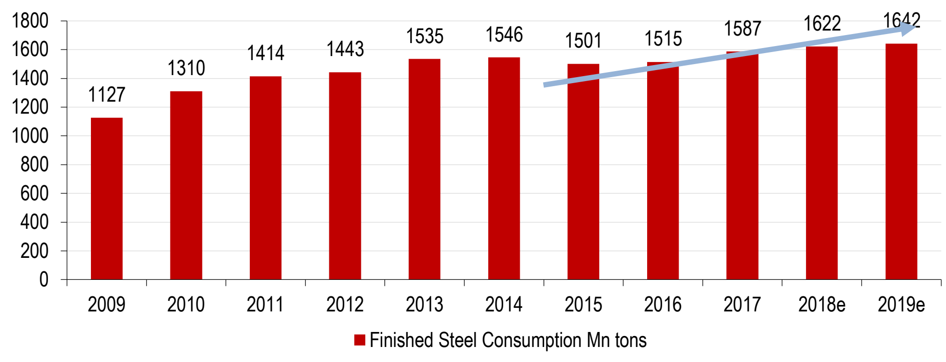
Source: Worldsteel Association

Why wild swings in steel prices are less likely

There are two important determinants to a commodity price – demand and supply.

Demand: China, the largest consumer of steel (approximately 45% share), has been growing its GDP at 6.8%. Our economists expect it to continue at around these levels in 2018 at 6.7% and to grow at 6.9% in 2019. With a neutral policy rate in 2018 and 2019 at the constant 3.4% level, and with macro indicators like industrial production, private consumption and exports pointing to a decent underlying demand, we expect steel demand to show sustained growth momentum at a CAGR of 0.5% over 2018-20e, with risks relatively limited in the years to come. However, we are concerned about sustained growth because environment protection being a prime concern has caused many construction and earthmoving activities to slow down for dust control and factory sewage permits are being re-evaluated. Hence, while we still expect overall demand conditions to remain stable, growth momentum is showing signs of slowing, especially in the property and infrastructure market (see *China Steel Sector: Margins holding up but valuations catching up*, published 5 February 2018).

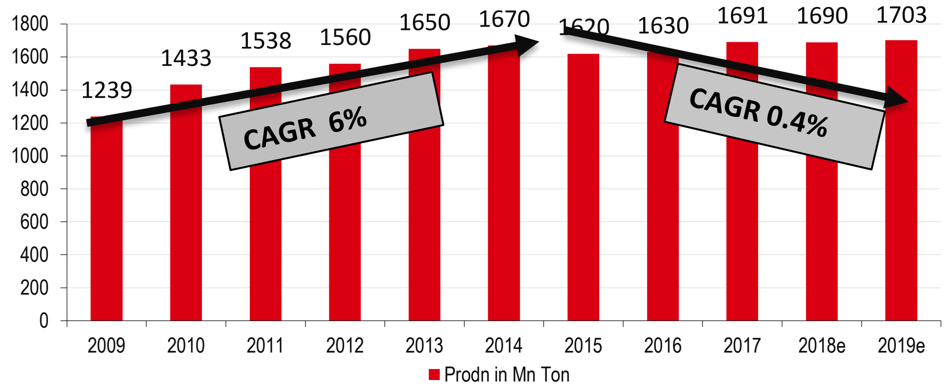
Demand growing at 2% CAGR from 2015, and we expect it to continue growing at a 1% CAGR over 2017-19e



Source: Worldsteel Association, HSBC estimates

Supply: On the other hand, supply is a fairly controllable determinant and China being the largest producer of steel has clamped down significantly on steel production. China continues to seriously pursue supply reforms, announcing plans to cut another 30mt of excess capacity this year. This should result in China largely achieving its long-term plan to cut 150mt in 2018 (vs. 2020).

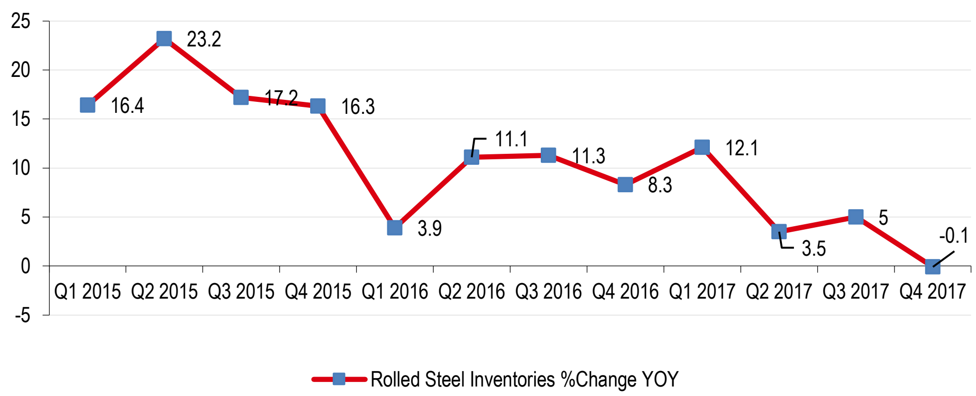
World steel production at constant levels since 2015



Source: Worldsteel Association, HSBC estimates

The Chinese rolled iron inventories were at its lowest levels in 4Q17. This was mainly due to the winter environmental shutdowns being strictly implemented. Although the shutdowns have ceased for majority of plants as of 15 March, for some specific areas, the ban has been extended until November 2018. The reduced inventory level is a testament to the effective production ban in China in the months of November-March, thereby destocking the steel levels.

Chinese rolled steel inventories on a decline



Source: Thomson Reuters Datastream

Upside risks to our Reduce rating on YZJ

- **Lower-than-expected steel prices:** An increase in interest rates in China in FY18 and FY19 may weaken the investment momentum. Also, the deceleration in growth of the Chinese economy due to structural reasons may weaken the demand for steel, thus lowering steel prices and positively influencing YZJ's operating margins.
- **Higher-than-expected new orders from outside China:** If competition for foreign orders from Korea and Japan slows down, we could see higher-than-estimated orders for YZJ in 2018-20e, just like we saw in 2017, which would provide an upside risk to our revenue and earnings estimates.

- **Weaker RMB against the USD:** While we expect the current RMB/USD rates to remain stable, any weakness in the RMB against the USD would benefit YZJ as YZJ's revenues are mostly in USD, which should provide an upside risk to our revenue estimates.
- **Higher-than-expected margins on existing order book:** We are building 0% gross margin on 67% of YZJ's current order book as the company has stated that it would not be making money on 67% of the current order book. However, any unforeseen reversals of impairment or losses could lead to upside risk to our margin estimates.
- **Higher-than-expected margins on new orders:** We are estimating 15% gross margin on new shipbuilding orders versus 18.2% reported in 2017, as we believe intensifying competition will lead to lower vessel prices. However, if competition abates, YZJ could make higher-than-estimated margins, leading to upside risk to our earnings estimates.

Valuation and risks for Keppel Corp (KEP SP, SGD8.21, Buy, TP SGD9.28)

We value KEP using a sum-of-the-parts (SOTP) methodology given that it is a conglomerate. We value the O&M (Offshore & Marine) business using DCF (unchanged key assumptions include 7.5% cost of equity, equity:debt ratio of 55:45, perpetuity growth rate of 2.0% and WACC of 6.0%) and the property business based on a RNAV methodology. We value the listed infrastructure and investment-related holdings based either on market price or, where applicable, HSBC's target price. We value the unlisted infrastructure and investment-related holdings on a PE multiple, and the Tianjin Eco City (TEC) investment on a RNAV methodology.

Our target price of SGD9.28 implies 13% upside. We rate the stock Buy as we think there is momentum driven by growth in its three key segments – property, infrastructure and investments.

Downside risks:

- **Oil prices decline:** At oil prices below USD40/b, we believe E&P companies would delay exploration capex, which would lead to a delay in rig orders that we expect to start coming in from 2019.
- **Ex-Petrobras orders in the order book could be delayed further:** While KEP has sorted out most of the issues with the buyers, in our view, any further unforeseen delays could lead to downside risks in our revenue and profit projections from 2018.
- **Property sector-related risks:** Hard landing for the property market in Singapore or China as a result of recession, sharply higher interest rates, or adverse policy action could lead to lower asset values and a reduced valuation for KEP. RMB depreciation versus the SGD is also a risk to NAV given the sensitivity of developments in China to RNAV.

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

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For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

As of 24 May 2018, the distribution of all independent ratings published by HSBC is as follows:

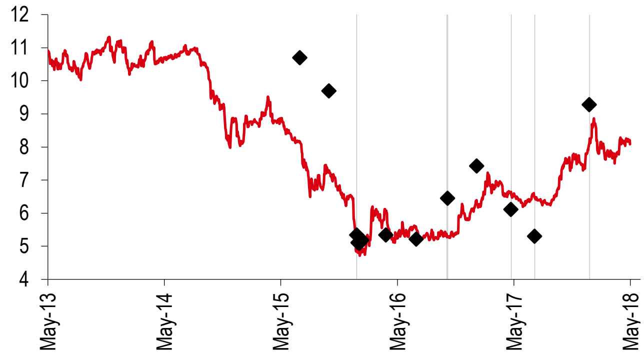
Buy	48%	(27% of these provided with Investment Banking Services)
Hold	41%	(26% of these provided with Investment Banking Services)
Sell	11%	(14% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

For the distribution of non-independent ratings published by HSBC, please see the disclosure page available at http://www.hsbcnet.com/gbm/financial-regulation/investment-recommendations-disclosures.

Share price and rating changes for long-term investment opportunities

Keppel Corp (KPLM.SI) share price performance SGD Vs HSBC rating history



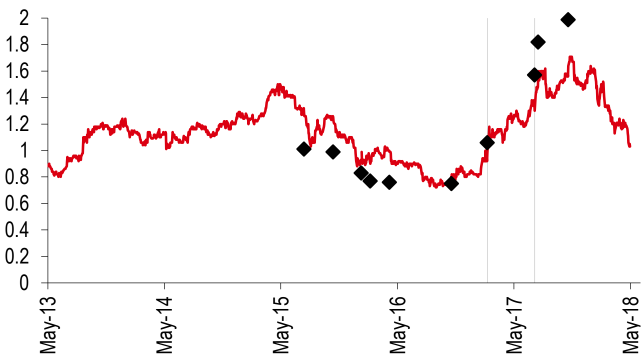
Source: HSBC

Rating & target price history

From	To	Date	Analyst
Buy	Hold	17 Jan 2016	Tarun Bhatnagar
Hold	N/A	25 Oct 2016	
N/A	Buy	28 Oct 2016	Somesh Agarwal
Buy	Hold	15 May 2017	Somesh Agarwal
Hold	Reduce	28 Jul 2017	Somesh Agarwal
Reduce	Buy	15 Jan 2018	Somesh Agarwal
Target price	**Value**	**Date**	**Analyst**
Price 1	10.70	23 Jul 2015	Tarun Bhatnagar
Price 2	9.70	22 Oct 2015	Tarun Bhatnagar
Price 3	5.34	17 Jan 2016	Tarun Bhatnagar
Price 4	5.11	21 Jan 2016	Tarun Bhatnagar
Price 5	5.09	25 Jan 2016	Tarun Bhatnagar
Price 6	5.18	02 Feb 2016	Tarun Bhatnagar
Price 7	5.34	18 Apr 2016	Tarun Bhatnagar
Price 8	5.21	22 Jul 2016	Tarun Bhatnagar
Price 9	N/A	25 Oct 2016	
Price 10	6.45	28 Oct 2016	Somesh Agarwal
Price 11	7.43	27 Jan 2017	Somesh Agarwal
Price 12	6.11	15 May 2017	Somesh Agarwal
Price 13	5.30	28 Jul 2017	Somesh Agarwal
Price 14	9.28	15 Jan 2018	Somesh Agarwal

Source: HSBC

Yangzijiang Shipbuilding (YAZG.SI) share price performance SGD Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date	Analyst
Reduce	Hold	01 Mar 2017	Somesh Agarwal
Hold	Buy	28 Jul 2017	Somesh Agarwal
Target price	**Value**	**Date**	**Analyst**
Price 1	1.01	05 Aug 2015	Tarun Bhatnagar
Price 2	.99	04 Nov 2015	Tarun Bhatnagar
Price 3	.83	31 Jan 2016	Tarun Bhatnagar
Price 4	.77	29 Feb 2016	Tarun Bhatnagar
Price 5	.76	29 Apr 2016	Tarun Bhatnagar
Price 6	.75	09 Nov 2016	Tarun Bhatnagar
Price 7	1.06	01 Mar 2017	Somesh Agarwal
Price 8	1.57	28 Jul 2017	Somesh Agarwal
Price 9	1.82	08 Aug 2017	Somesh Agarwal
Price 10	1.99	10 Nov 2017	Somesh Agarwal

Source: HSBC

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Company	Ticker	Recent price	Price date	Disclosure
KEPPEL CORP	KPLM.SI	8.08	23 May 2018	6

Source: HSBC

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