

**GICS:** Energy/Oil & Gas Storage & Transportation

**Business Summary:** China Aviation Oil's (CAO) principal activities are in jet fuel procurement, supply and trading, trading of oil products and investment in oil related assets. The company was incorporated in Singapore on May 26, 1993. It was listed on the mainboard of the SGX on Dec. 6, 2001.

**Country of Incorporation:** Singapore

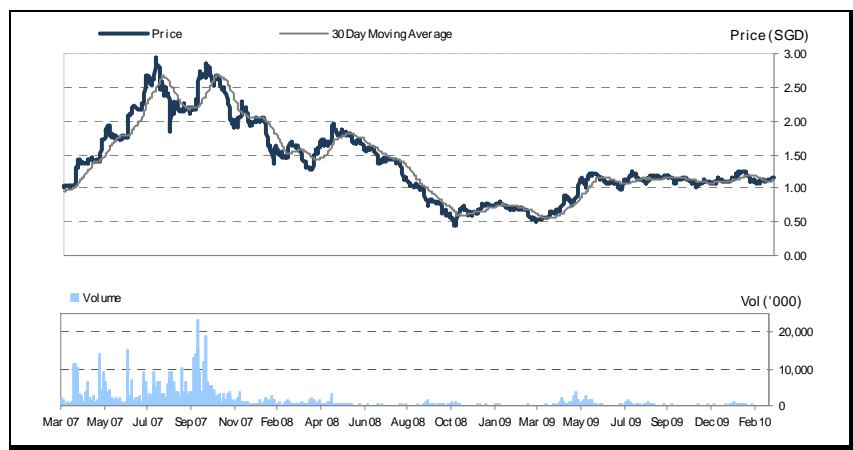
**Head Office Location:** 8 Temasek Boulevard, #31-02  
Suntec Tower Three, Singapore 038988

**Place of Operations:** Singapore

**Website:** www.caosco.com

**IR Contact:** Doreen Nah | doreennah@caosco.com | +65-6330 1205

**Analyst:** Lorraine Tan, CFA ; Samuel Seah



## Investment Highlights

- CAO has a niche function in China's downstream energy industry as a supplier of imported jet fuel to the three key international airports in the country. Its parent enjoys a near-monopoly as the main provider of jet fuel to more than 140 airports in China, while CAO has more than 90% share of China's jet fuel import market.
- CAO's unique business function and operating structure, where it earns fixed commissions on jet fuel procured and supplied reduces the risk to its profitability from oil price fluctuations. We also expect China's jet fuel imports to increase, due to the expansion of China's aviation market.
- The company has been able achieve decent compounded annual recurring earnings growth of 13.2% in the three years to 2009 following its restructure in 2004-2006 and steps have been taken to improve its risk management and corporate governance procedures. A Business Co-operation agreement with BP should help reduce trading risk.
- We project CAO's net profit to increase 18.6% YoY in 2010 to USD53.6 mln and 9.4% YoY in 2011 to USD58.6 mln. We see earnings driven by higher jet fuel procurement volumes on the back of strong growth in air travel.
- Its ROAE, meanwhile, is expected to rise to 17%-17.5% in 2010 and 2011, respectively from 15.4% in 2009. CAO is also in a strong financial position, being net cash at end-2009.

## Key Investment Risks

- **Policy and regulatory changes.** CAO is dependent on its parent company retaining its monopoly as the main provider of jet fuel to the three key international airports in China. Any changes to this arrangement may lead to a decrease in the volume of jet fuel procured by CAO.
- **Increase in domestic production of jet fuel.** An increase in China's domestic refining capacity may reduce the quantity of jet fuel imported.
- **Risk management failures.** Operational failures in executing its risk control measures may result in substantial losses from the oil trading business.
- **Control of Associate companies.** CAO's associates are key contributors to its income and the lack of management control over these associates and lower operational transparency may reduce CAO's earnings quality and raise risk to our earnings estimates for CAO.

### Key Stock Statistics

52-week Share Price Range (SGD)	1.02 - 1.25
Avg Vol - 12 months ('000 shares)	219.9
Price Performance (%)	
- 1 month	5.5
- 3 month	6.5
- 12 month	90.1
No. of Outstanding Shares (mln)	722.8
Free Float (%)	29.1
Market Cap (SGD mln)	831.2
Enterprise Value (SGD mln)	1,250.8
Major Shareholders (%)	
China National Aviation Fuel Group Corpo	50.9
BP Investments Asia Ltd	20.0

\* 2009 DPS converted at at SGD0.71:USD1.00, post-2009 DPS converted at SGD0.70:1

### Per Share Data

FY Dec.	2008	2009	2010E	2011E
Book Value (US cents)	38.14	42.85	43.63	49.97
Cash Flow (US cents)	5.4	6.3	7.5	8.1
Reported Earnings (US cents)	5.3	6.3	7.4	8.1
Dividend (US cents)	1.4	1.4	1.8	1.9
Payout Ratio (%)	26.2	22.8	23.7	23.8
PER (x)	15.5	13.1	11.1	10.1
P/Cash Flow (x)	15.3	13.0	11.0	10.1
P/Book Value (x)	2.2	1.9	1.9	1.6
Dividend Yield (%)	1.7	1.7	2.1	2.4
ROE (%)	14.1	15.4	17.1	17.3
Net Gearing (%)	0.0	0.0	0.0	0.0

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**Background**

China Aviation Oil (S) Corp's (CAO) primary business is to supply jet fuel to China. Incorporated in Singapore on May 26, 1993, the company was subsequently listed on the main board of the Singapore Exchange on Dec. 6, 2001.

Originally established as a joint venture between China State Owned Enterprises (SOEs) China Aviation Oil Supply Corporation (CAOSC) and China Foreign Trade Transportation Corporation (SINOTRANS) and Singapore shipping company Neptune Orient Lines (NOL), the aim at that time was to embark on marine transportation services.

In Feb. 1995, CAOSC acquired SINOTRANS' and NOL's stakes in the company and CAO became a wholly owned-subsiidiary of CAOSC where it became the investment arm of CAOSC outside China. Its core activity was then changed to become jet fuel procurement into China. Subsequently in 2003, on the restructure of CAOSC, ownership of CAO was transferred to China National Aviation Fuel Corporation (CNAF) who remains CAO's major shareholder. CNAF enjoys a near monopoly as the largest jet fuel supplier in China, with rights to distribute to more than 140 airports.

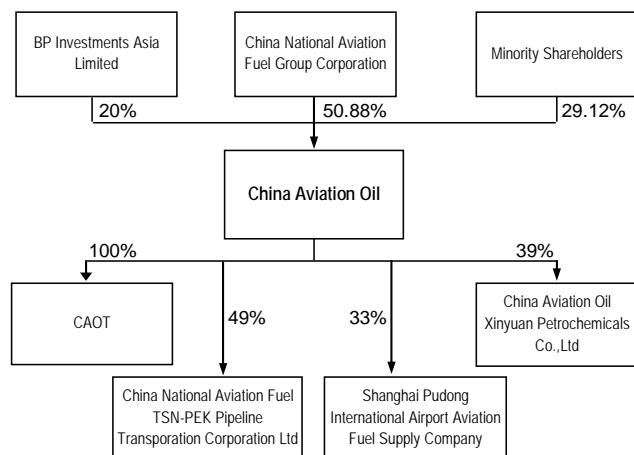
**CAO's Restructure Brings in BP, Helps Manage Trading Risk**

In 2004, CAO suffered steep oil trading losses leading to its restructure in 2006 following a 16-month suspension and the introduction of oil major BP Plc as a substantial shareholder. CNAF remains the single largest shareholder of the company, with a 51% stake. BP's interest is through BP Investments Asia with 20%. BP provides its risk management expertise to CAO's trading activities. In 2008, CAO recommenced jet fuel hedging and trading activities, as part of its efforts to optimise operations.

At present, CAO is the largest purchaser of jet fuel in the Asia Pacific region and key supplier of imported jet fuel to PRC's civil aviation industry, with a market share of more than 90%.

CAO is led by Chief Executive Officer, Mr. Meng Fanqiu. Prior to joining CAO, Mr. Meng was the Division Director of the Planning and Development Division of CNAF, and is experienced in strategic planning, investment, company reform and legal policy. As a qualified legal attorney and corporate legal advisor, he was also involved in the drafting and enacting of the PRC Civil Aviation Law.

**Corporate Structure**



Source: Company data

**Board Independence**

CAO's board consists of nine directors, of which three are independent; four are nominees from CNAF and two from BP. While we believe that board independence can be further improved with a higher number of independent directors, we take comfort that there is a clear separation between the Chairman (who is non-executive and independent) and the CEO role. In addition, the major shareholder CNAF does not have clear board control since it can be outvoted by the other five members. Independent directors also head the Audit, Remuneration and Nominating Committees. In addition, the Risk Management Committee is chaired by Mr. Timothy Bullock, who is currently the Chief Operating Officer, Global Oil, of BP International Ltd who has over 20 years of global energy industry experience.

**Board of Directors**

Name	Title	Date of Appointment as Director
Dr Wang Kai Yuen	Independent Chairman	November 2008
Sun Li	Deputy Chairman/Non-Executive & Non-Independent	April 2007
Meng Fanqiu	Chief Executive Officer/ Executive Director	November 2008
Zhang Zhenqi	General Manager (Trading)/ Executive Director	June 2007
Dr Zhao Shousen	Non-Executive & Non-Independent Director	March 2006
Liu Fuchun	Independent Director	March 2006
Timothy Bullock	Non-Executive & Non-Independent Director	May 2008
Chen Liming	Non-Executive & Non-Independent Director	August 2009
Ang Swee Tian	Independent Director	November 2008

Source: Company data

**Key Management**

Name	Title	Date of Appointment
Meng Fanqiu	Chairman Executive Officer/Executive Director	May 2008
Zhang Zhenqi	Executive Director/General Manager (Trading)	June 2007
Wang Chunyan	Chief Financial Officer	September 2007
Doreen Nah	Head of Legal/Company Secretary	April 2007
Tee Siew Kim	Head of Finance	June 2006
Jean Teo	Head Of Trading	January 2008
Oi Mow Lie	Head of Risk Management	January 2008

Source: Company data

**Restructure / Steps Taken to Mitigate Future Risk**

CAO's travails with its 2004 oil options trading losses have been well documented. In Nov. 2004, a wrong bet on oil prices resulted in estimated trading losses of USD550 mln, wiping out the company's reserves. However, the company took steps to ensure that assets were protected from debtors and subsequently undertook an extensive restructure to cover losses and repay debt. The total capital restructure (debt and equity) took all of 2005 to undertake and completed in 2006, during which time CAO was suspended from trading on the SGX. Minorities in the end saw a 5:1 consolidation of their shares.

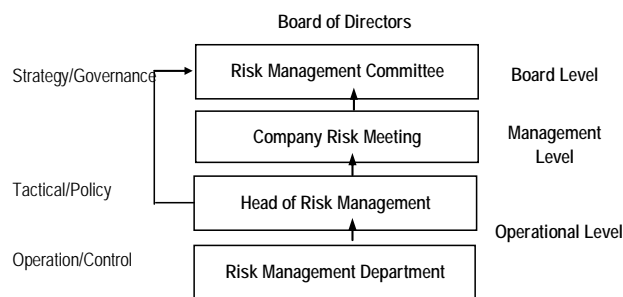
Concurrently and as importantly, the Company also raised its risk management and corporate governance procedures. A key step involved the setting up a Business Co-operation agreement with BP so that the latter's trading and risk management expertise was imparted to CAO's trading operations.

Essentially, CAO set up a risk management committee, headed by BP's representatives, to oversee all trades and monitor the risk of each and every deal. Limits have been set, more sophisticated risk software employed and there is a clear segregation of duties. One policy includes having the risk management head report directly to the Board of Directors and not the CEO.

To this day, the heads of CAO's Trading and Risk Management activities are seconded from BP. For further corporate governance, CAO's business development head is also seconded from BP. This is part of BP's requirement in its 20% ownership of CAO.

Other steps taken include in the introduction of trading guidelines, risk management manuals and a whistle-blowing policy. As part of its greater caution in managing its position, CAO has also been in a net cash position since 2007.

**Risk Management Framework**

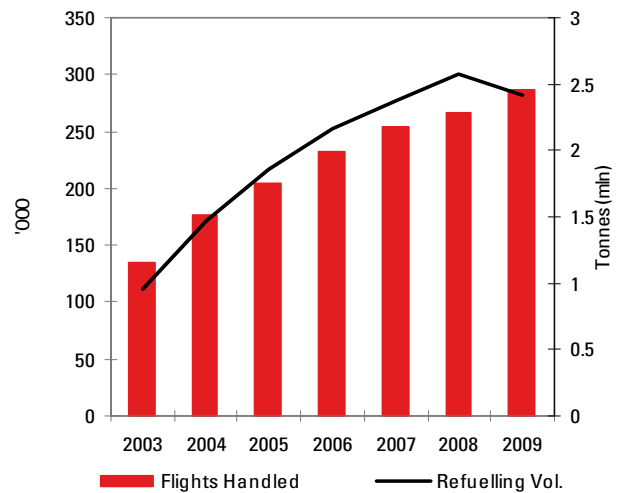


Source: Company data

**Key Subsidiaries & Associates**

- 33%-owned Shanghai Pudong International Airport Aviation Fuel Supply Company Ltd (SPIA), is engaged in the procurement, sales, transportation, storage and refueling of jet fuel for Shanghai Pudong International Airport.

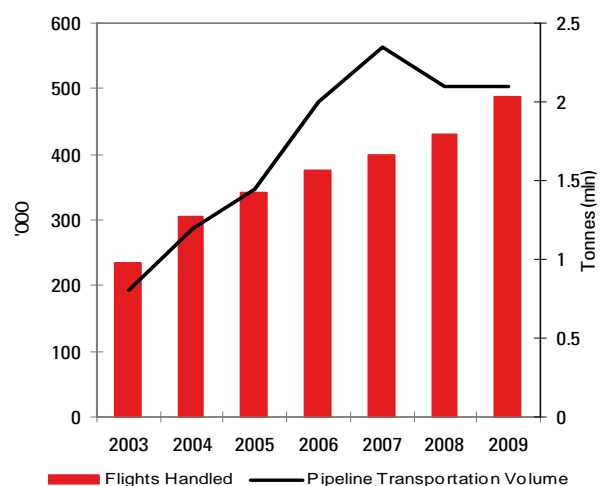
**Flights handled at Shanghai Pudong Airport vs. SPIA Refuelling**



Source: Company data

- 49%-owned China National Aviation Fuel TSN-PEK Pipeline Transportation Corporation Ltd (TSN-PEKCL), which was acquired in February 2009, provides logistics and storage services for the jet fuel requirements of Beijing Capital International Airport (BCIA) and Tianjin Airport.

**Flights handled at BCIA vs. TSN-PEKCL Pipeline Volume**



Source: Company data

- 39%-owned China Aviation Oil Xinyuan Petrochemicals Co. Ltd (Xinyuan) provides storage services and trades in jet fuel and other oil products.

**Business Segments / Key Revenue Streams**

**Jet fuel supply and trading**

Jet fuel supply is CAO's core business segment and also its main revenue contributor. The company is responsible for the procurement and supply of jet fuel to the three key international airports in China, namely Beijing Capital International Airport, Shanghai Pudong International Airport and Guangdong Baiyun International Airport.

According to CAO and backed up by industry data from the China Petroleum and Chemical Industry Association, CAO accounts for more than 90% of jet fuel imported into the PRC and approximately 40% of China's jet fuel requirement since 2005. This is primarily due to CNAF owning the indefinite right from the central government to import jet fuel from overseas markets, and CAO benefits as the sole sourcing agent.

CAO is paid a fixed spread (USD) for each barrel of jet fuel supplied and hence is assured of fixed commissions. Based on our estimates, it has been paid between USD0.30 – 0.40/bbl of jet fuel in the past five years. Its counterparties are: (i) SPIA (Shanghai), (ii) China National Aviation Fuel Corporation Limited Huabei (Beijing) and (iii) China National Aviation Fuel South China Bluesky Corporation (Guangdong). Contracts with its counterparties are negotiated on a two years renewable basis.

CAO also engages in jet fuel trading operations and it trades jet fuel with customers from other countries beside the PRC. CAO will normally put in a bid when there are invitations to tenders from customers. If its bid is accepted, the company will proceed to fulfill the order from the cargo on hand. Jet fuel trading is very competitive and as a result, profit margins are usually smaller than procurement and supply.

**Trading of petrochemicals and other oil products**

CAO re-established its petrochemicals trading business in October 2008 and oil and diesel trading in the third quarter of 2009. This started after the company inherited BP's Asia petrochemicals portfolio and trading team. Turnover from this segment only contributes a nominal 2.7% of its total 2009 revenue. While revenue contributions are currently small, the company believes that the team can leverage on its strong business linkages to grow the segment in China. The company has also started trading fuel oil and gas oil in 2H09 but again the quantum is not significant as is being undertaken as a "trial" to see if activity can be built up.

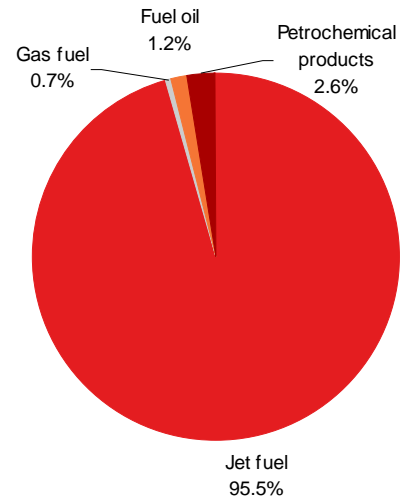
**Investment in oil-related assets**

The company aims to acquire, develop and control physical infrastructure and assets across the jet fuel supply chain. This includes investment in refineries, tank farms, pipelines and jetties that are near supply centres and demand sources. These investments are looked upon as synergistic to its whole supply operations as it seeks to improve efficiency and reduce cost.

**Others**

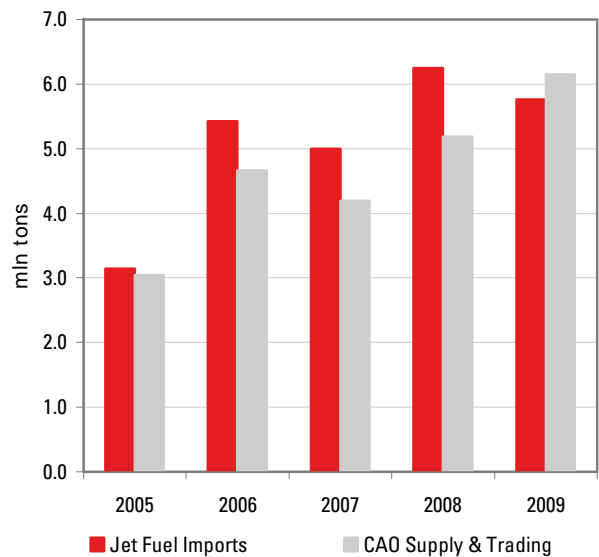
CAO is also involved in the export of jet fuel from independent Chinese refineries to markets outside of the PRC. The company recently signed cooperation deals with West Pacific Petrochemical Corp. (WEPEC) in 2009 and CNOOC's Huizhou refinery in 1Q10. Nevertheless, supply may vary and contribution to revenue/profits is likely to be insignificant in the near term.

**2009 Revenue Breakdown by Fuel Segment**



Source: Company Data

**CAO Jet Fuel Supply & Trading Volume vs. China Jet Fuel Imports**



Note: CAO's 2009 jet fuel supply and trading exceeded China's total imports of jet fuel based on CEIC data tracked to the China Petroleum & Chemical Industry Association figures. The higher volume by CAO is probably due to trading and hedging related tonnage that does not go into China. However, we are unable to extrapolate more accurate figures in the absence of more information from CAO.

Source: CEIC, Company Data

**Industry Landscape**

**China's Oil & Gas Industry Structure**

CAO has a niche function in China's downstream energy industry as an importer of jet fuel supplied to three key international airports in the country. Its parent enjoys a near-monopoly as the main provider of jet fuel to more than 140 airports in China. This dominant position arises from the communist/planned economic system with government agencies still controlling most of the economy. As such, some portion of China's energy sector is not fully open to competition yet and remains controlled by a few key state owned enterprises (SOE). While this may transform ultimately, we believe it is unlikely to change in the near term in light of the government's priority to maintain energy supply and pricing stability. Energy security has been a key tenet of the government's five year plans.

The controlled pricing of downstream pricing for diesel, gasoline and jet fuel tends to deter the entry of multi-national oil companies. In addition, China's upstream oil & gas industry is dominated by three SOEs, China National Petroleum Corp. (CNPC), China Petroleum & Chemical Corp. (aka Sinopec) and CNOOC, which further adds barriers to the entry by the international oil companies since more inefficient integrated operations within China are not easily accessible. Since jet fuel comprises a small portion of the downstream activity for CNPC and Sinopec, it is also unlikely that these two would step into CAO's role while CNOOC prefers to avoid downstream activities subject to price controls based on prior conversations with the company's management.

It is also physically difficult to just build a jet fuel refinery since the refining process itself generates a variety of petrol products and given the costs involved, is generally most viable to produce a larger proportion of diesel and gasoline. China's largest refiner, SNP Shanghai Petrochemical's kerosene (umbrella product mainly made up of jet fuel) output makes up around 7%-8% of its sales by volume. Hence, refiners will plan their expansion around the demand for gasoline and diesel and not jet fuel. As such, we would expect China to remain a net importer of jet fuel for the foreseeable future.

Having said this, refiners do have the ability to switch some production to jet fuel if demand drives prices firmer allowing for better margins. These, however, tend to be temporary and seasonal product mix moves.

**China's Aviation Industry Structure**

China is the second largest aviation market in the world and also one of the fastest growing aviation industries. While its domestic sector remains closed to foreign airlines, foreign players compete with PRC airlines on the international and regional segments. Three state-owned airlines: Air China, China Eastern Airlines and China Southern Airlines, each has about 50% market share in their hubs in Beijing, Shanghai and Guangdong, respectively.

According to the Civil Aviation Administration of China (CAAC), around 405 mln passengers passed through China's airports in 2008 (latest available information), an increase of 4.7% from the previous year. Aircraft maker Airbus said in a 2008 report that the China's aviation market will see an annual passenger increase of 7.9% in the next 20 years.

Major transportation infrastructure projects will continue to receive funding from the central government under its CNY4.0 trillion (nearly USD600 bln) stimulus package to reinvigorate the economy. The building of airports will be a key investment item and the CAAC targets to increase the number of airports to 244 by 2020, from 148 at the end of 2007.

Meanwhile, China will retain its hub-to-hub focus to improve domestic air traffic connectivity, and construction work at airport hubs will be strengthened. Around 50 landing slots at major airport hubs, especially in Beijing, Shanghai Pudong and Guangzhou will be added to handle new and additional routes.

**Demand and Supply Outlook for Jet Fuel**

Since CAO only serves as the importer of jet fuel into the Beijing, Shanghai and Guangdong airports and is paid a fixed price based on volume, its revenue outside of its other trading and hedging activities is not subject to price fluctuations. As such, we are focusing our industry outlook on the expected demand and supply outlook as it pertains to volume and less on the pricing aspects.

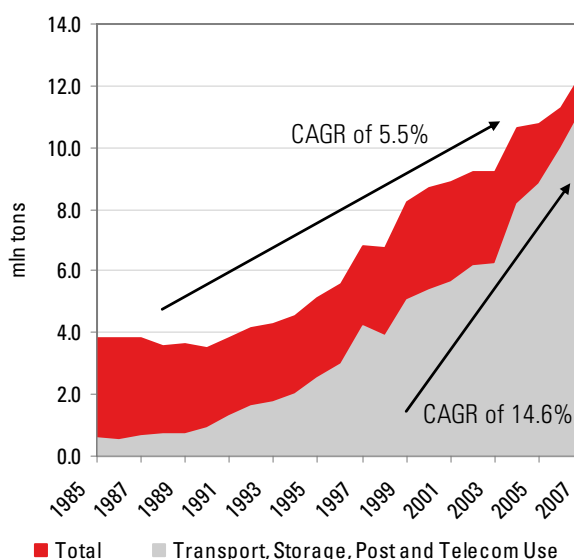
Furthermore, the jet fuel imported in by CAO is meant to supply international airlines. If there is a shortage of domestic jet fuel supply, the imported fuel is then channelled, in terms of priority, towards Chinese airlines departing for international destinations and then only to domestic flights. Since China is a net importer of oil and petrol products, it is unable to fully meet demand solely through domestic sources. Hence we believe the aim of the authorities in differentiating the users is to ensure international airlines are subject to global prices and not China's set prices as this may or may not reflect prevailing market prices. It also ensures that it is only the Chinese who will benefit from any subsidies, if available, but mainly it removes pricing volatility making it easier for domestic airlines to price their flights since fuel cost hedging is limited.

**Domestic traffic remains the impetus for growth**

China's three largest airline groups all experienced significant year-on-year growth in passenger traffic in 2009. Domestic airlines carried a total of 230 million passengers last year, up a massive 20% YoY. This was driven by robust domestic traffic growth and partly helped by a recovery in international passenger traffic towards the end of the year.

We see domestic air traffic remaining the main driver of aviation growth in China in 2010 and into 2011. Strong and sustainable economic growth in the country will no doubt lead to a gradual expansion of personal wealth and hence, the affordability of air travel. While CAO's activities are tied more closely to international air traffic into and out of China, we still expect positive growth of 10%-13% underpinned by rising wealth in China. Standard & Poor's Economists expect China's GDP to increase by 9.7%-10.2% in 2010.

**Strong China Demand Growth of Kerosene\* for Transport Use**



Source: CEIC \*Jet fuel is a derivative of kerosene and its most widely used product incarnation

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**Further liberalization of cross-strait flights will boost regional traffic**

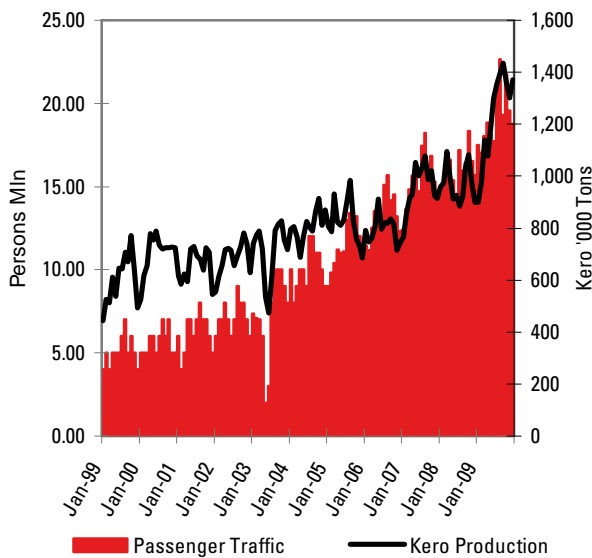
As of end-Aug. 2009, the number of cross-strait flights to Taiwan was increased to 270 services per week from 108 previously, and further negotiations are underway for another doubling of flights by end-2009. Cargo frequency also increased from 30 to 112 return services per month. This is a positive move for airlines in both China and Taiwan, as the strengthening of ties between the two countries will boost regional traffic, particularly when passenger numbers and cargo demand from international routes remains fragile.

**Shanghai Expo, Guangdong Asian Games to Drive 2010 Growth**

Looking ahead, we project passengers carried by the three state-owned airlines to increase by 13% in 2010 and 10% in 2011. Keys events like the Shanghai Expo and the Guangdong Asian Games this year will likely be the catalysts for higher international and regional traffic in/out of China. This is on top of the expected expansion in economic activity that will support air traffic growth.

The demand for jet fuel import into the PRC is expected to grow along with the expansion of China's aviation market. Moreover, we expect some additional stock piling of imported jet fuel in 2010 that will likely lift the supply of jet fuel to PRC.

**Kero Production Increasingly Correlated to Passenger Traffic**



Source: CEIC

**Growth Strategy**

The Company aims to be (i) the regional leader in the jet fuel supply and trading business and (ii) an important player in the other fuel segments. Management said that it will concentrate on growing its business in the Asia Pacific region (Singapore, HK, Australia, Indonesia, Vietnam and India) and it is also in the hunt for business opportunities in Europe and the west coast of the USA.

As part of the company's long term strategic plan to be more than a jet fuel procurement set-up, efforts have been on-going to improve on its fuel supply capabilities. CAO may look to invest in more oil logistics related assets over the next two to three years so as to help the company service its clients more efficiently and at a lower cost.

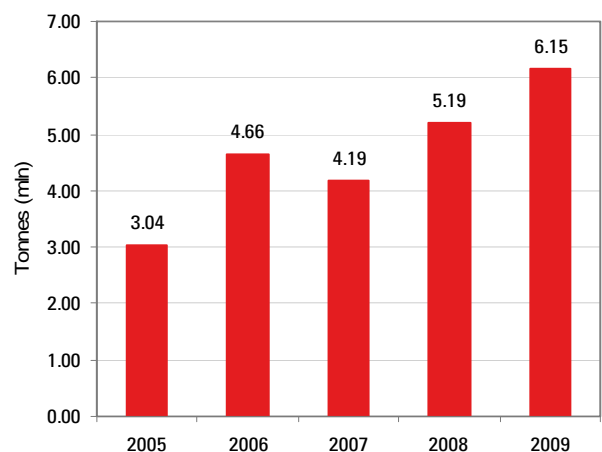
These include fuel storage facilities like tank farms and jetties and also pipelines. The company is likely to look for assets in China, Korea, Malaysia and Thailand, as it prioritizes target purchases based on proximity to suppliers and/or buyers. The company may also consider adding shipping vessels and/or enter into longer term shipping charters to better manage its freight cost and improve flexibility in delivery.

As jet fuel delivered is priced at the previous month's Mean of Platts price (MOP-1), which may differ from CAO's purchased price, the company resumed jet fuel hedging activities in February 2008 to mitigate pricing risk. The company will continue to hedge its jet fuel procured that will help optimise its margins.

Meanwhile its plans to invest in oil-related assets around the region may help the company increase its fuel storage and supply capacity. This will increase its competitiveness in trading activities, due to greater economies of scale, and improve its trading margins.

After re-establishing its petrochemicals trading business in October 2008 and oil and diesel trading in 3Q09, CAO is expected to ramp up its trading activities in its other fuel products segment going forward. Management said that the company may be adding more traders (currently only two) in 2010.

**Jet Fuel Supply and Trading Volumes**



Source: Company data

## SWOT Analysis

### Strengths

- CAO has a dominant position in the PRC jet fuel market and supplies over 90% of all jet fuel imported into China.
- Guaranteed margins on jet fuel supplied to PRC.
- Able to tap on the extensive distribution network and infrastructure established by parent company CNAF.
- BP is a strategic investor and CAO is able to leverage on BP's technical expertise, networks and gain international exposure.

### Weaknesses

- It is heavily reliant on its Parent company, its subsidiaries and associated companies, to continue to import jet fuel from the company.
- Its results and financial conditions are highly susceptible to changes in the PRC's political, economic and social conditions as its revenue remains substantially derived from its operations in the PRC.
- Business growth remains highly dependent on the growth of the international aviation market in the PRC.
- Social responsibility in ensuring a steady supply of jet fuel to the PRC may result in higher than required stock piling.
- May have limited bargaining power in seeking higher margins on jet fuel supplied to its parent and related companies.

### Opportunities

- Further acquisition of synergetic assets along the supply chain will help optimize operations, increase pricing, distribution flexibility and additional cost savings.
- Expansion of its jet fuel supply business to other countries.
- Greater economy of scale from expanding its jet fuel supply and oil trading businesses.

### Threats

- Opening up of the PRC jet fuel import market, which may lead to greater competition and lower jet fuel procured through the company.
- Increase in PRC domestic refining capacity may reduce the quantity of jet fuel import from overseas.
- Profits may be negatively affected by adverse and/or volatile movements in the prices of oil products the company trades.
- Operational failures in executing its risk control measures that may result in substantial losses from the oil trading business.

## Recent Key Developments

December 2009: Announced that the company and BP Singapore (BPS) renewed their interim trading agreement (ITA 2010), where BPS agreed to supply part of the its aviation fuel requirements for onward supply to the PRC. ITA 2010 is effective from Jan. 1, 2010.

June 2009: Entered into a cooperation framework agreement with West Pacific Petrochemical Co., Ltd.

April 2009: Entered into a cooperation framework agreement with CNOOC to purchase a portion of CNOOC Huizhou Refinery's total export quota for jet fuel.

February 2009: Completed the acquisition of a 49% of equity capital in China National Aviation Fuel TSN-PEK Pipeline Transportation Corporation Ltd (TSN-PEKCL).

## Management Guidance

Management does not expect any change to its dominant position as the main importer of jet fuel to the PRC in the near to mid term. It pointed out that: (i) local refiners remain incapable of meeting the demand for jet fuel in China, (ii) its position as a government-linked agency, which is important in ensuring stable/secure supply of jet fuel to China and (iii) the high barriers to entry may keep competitors out of the market.

Management expect jet fuel procured and supplied in 2010 to increase, driven by double digit growth in aviation traffic in PRC. It noted that: (i) the Shanghai Expo that will open from May 1 to Oct. 31 is projected to bring in 70 mln visitors and 200 participants to Shanghai (ii) the Guangzhou Asian Games, from November 12 - 27, is projecting 100,000 visitors and athletes to the Southern Chinese City. Increased jet fuel stock piling is expected in 2010, similar to during Beijing Olympic Games in 2008.

Company expects associate contributions to increase in 2010. SPIA will remain its main contributor; note that the high cost inventory was expanded by 2Q09-3Q09. More gradual increase in profits from PEK and Xinyuan (does not expect significant profit contribution from its petrochemical operations in the next few years).

## Earnings Outlook

### 2009 Results Review

In 2009, the company reported a full-year net profit of USD45.2 mln (+17.9% YoY) that is mainly due to: (i) a 36.3% YoY increase in gross profit to USD30.7 mln on higher volumes and better operating leverage and (ii) higher associates contribution of USD24.2 mln (+129.9% YoY).

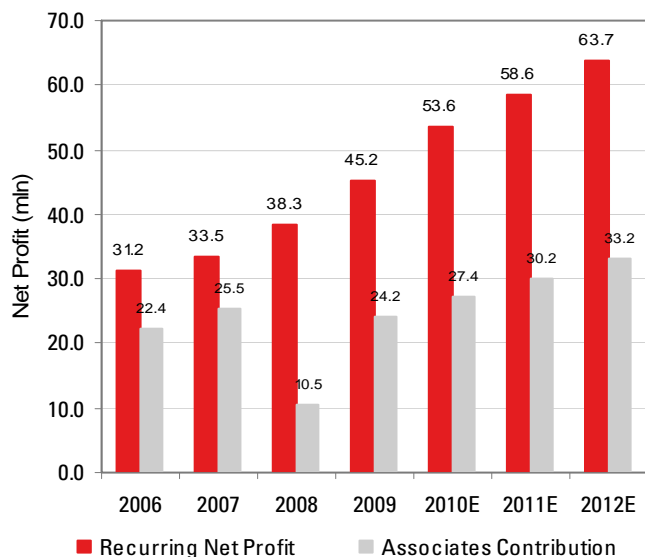
During the year, the total volume of jet fuel procured and traded increased 18.5% to 6.15 mln tonnes. This is primarily driven by higher jet fuel trading volume. Nevertheless, we expect the amount of jet fuel procured to have declined slightly as compared to the year before due to a 3.4% fall in international passenger traffic.

The higher gross profit achieved was due to better jet fuel trading margins on enhanced operating leverage as volume increased, with the fixed commission on jet fuel procured and supplied remaining unchanged from 2008. We believe that the company may have also benefited from lower freight charges last year following the decline in transport charges. Gains were partly dampened by a loss of USD823,000 from the trading of other oil products.

Of its associates, SPIA remains the main contributor with a net profit of USD20.9 mln (+101% YoY), TSN-PEKCL added USD2.9 mln (in operation since end-February 2009) and Xinyuan reported a net profit of USD283,000. The bounce in SPIA profit was due to the absence higher cost and excess inventory that hurt 2008 income. To recap, SPIA had assumed higher jet fuel requirements in 2008 in conjunction with the Beijing Olympics but demand fell short of expectations.

CAO did not pay any tax in 2009 as there are adequate tax losses carried forward from prior years that largely offset the company's profit in the current year.

**Recurring Net Profit & Associates Contribution (2006 – 2012E)**



Source: Company data

Looking forward, we project CAO's net profit to grow by 18.6% YoY in 2010 to USD53.6 mln and 9.4% YoY in 2011 to USD58.6 mln. Its ROAE, meanwhile, is expected to rise to 17%-17.5% in 2010 and 2011 respectively (2009: 15.4%).

We expect the stronger earnings growth to be driven by: (i) increased jet fuel procured and supplied, (ii) higher jet fuel trading volume and (iii) improved contributions from SPIA with the normalising of its operations. Unlike the Beijing Olympics, the 2010 Shanghai Expo is spread out over a longer period (six months) and authorities and SPIA management have learned from the 2008 experience so as to not store up as much additional inventory of jet fuel. As such, we do not expect a repeat of the 2008 excess inventory situation to mar profit performance.

In our 2010 earnings forecast, we have factored in the following:

- An 18% YoY increase in jet fuel procured to 7.26 mln metric tonnes, on the back of a recovery in international air traffic in China, additional stock piling of imported jet fuel due to the Shanghai Expo and an increase in trading volume.
- Gross fixed commission of USD0.38/bbl of jet fuel procured as we expect its procurement and supply contracts to be renewed on similar terms to its current ones in 2010.
- Higher operating cost of USD9.5 mln (+15.4% YoY) due to an increase in administrative expense as the company is expected to add more trading positions this year.
- Net profit contribution from SPIA of USD25.2 mln (+20.3% YoY) on higher refuelling volume of 2.88 mln tonnes (+19.6 % YoY). We believe that the associate will benefit from increased refuelling volume, driven by higher air traffic throughput in Shanghai this year due to the Shanghai Expo.
- Zero tax expense with tax losses carried forward from prior years still sufficient to offset its profits.

While we believe that CAO may be looking for oil-related asset investments this year and next, it has not announced any concrete capital

expenditure plans as yet. Hence we have not factored higher capital expenditures into our earnings forecast.

We understand from management that tank farms in China, with capacity of 300,000 to 500,000 cubic meters will cost approximately USD100 mln. In more developed markets like Korea and Singapore, a tank farm of the same capacity will cost more. Therefore we think it is likely that the company will raise borrowings and/or enter in joint ventures with other corporations to acquire such assets.

Nevertheless, we believe that CAO is in a strong financial position to tap the debt markets for capital investment and expansion, with the company in a net cash position (zero debt) of USD182 mln at end-2009.

**Peer Comparison**

We do not identify any direct peer comparables to the company due to its unique business function and operating structure - near monopoly of the China's jet fuel import market; fixed commissions on jet fuel procured and supplied. Therefore we compare CAO against listed refiners within the same energy sector, who are affected by similar market conditions.

	CAO	SNP Shanghai Petrochem	SK Energy	Shell Refining
<b>Currency</b>	SGD	HKD	KRW	MYR
Share Price @ 5 Mar 10	1.15	2.85	112,000	10.70
Mkt. Cap (mln)	839	51,542	10,356,143	3,210
PER Historical (x)	21.7	N.A. (loss)	18.6	7.1
PER Current Year (x)	11.0	7.0	9.7	12.2
P/NTA Historical (x)	1.93	1.52	1.17	1.43
<b>Latest FY</b>				
Pre-tax Profit Margin (%)	1.24	6.46*	2.29	4.34
Net Profit Margin (%)	1.24	4.73*	1.87	3.24

Source: Bloomberg, Company Data, S&P Equity Research

\*Based on unaudited HY09 earnings as the latest FY data has not been released.

**Profit & Loss**

FY Dec. / USD mln	2008	2009	2010E	2011E
Reported Revenue	5,370.2	3,634.3	5,118.2	5,687.9
Reported Operating Profit	17.6	22.4	26.6	28.9
Depreciation & Amortization	-0.7	-0.5	-0.4	-0.2
Net Interest Income / (Expense)	4.5	0.0	-0.4	-0.5
Reported Pre-tax Profit	33.5	45.2	53.6	58.6
Effective Tax Rate (%)	NM	0.0	0.0	0.0
Reported Net Profit	38.3	45.2	53.6	58.6
Reported Operating Margin (%)	0.3	0.6	0.5	0.5
Reported Pre-tax Margin (%)	0.6	1.2	1.0	1.0
Reported Net Margin (%)	0.7	1.2	1.0	1.0

Source: Company data, S&amp;P Equity Research

**Balance Sheet**

FY Dec. / USD mln	2008	2009
Total Assets	495.1	758.7
Fixed Assets	8.3	8.1
Current Assets	404.6	599.6
Other LT Assets	82.2	151.0
Current Liabilities	219.4	449.0
LT Liabilities	0.0	0.0
Share Capital	215.6	215.6
Shareholders' Funds	275.7	309.7

Source: Company data, S&amp;P Equity Research

**Cash Flow**

FY Dec. / USD mln	2008	2009	2010E	2011E
Operating Cash Flow	-115.9	53.1	-42.1	29.1
Investing Cash Flow	5.2	-13.4	0.5	0.5
Financing Cash Flow	-36.7	-10.6	-11.3	-13.8
Net Cash Flow	-147.4	29.1	-53.0	15.9
Ending Cash	153.1	182.2	129.2	145.1
Capex	-0.1	-0.1	-0.1	-0.1

Source: Company data, S&amp;P Equity Research

**Material Disclosures Including Interested Party Transactions**

Nil

**New Issues & Placements**

Nil

**Dividend Policy**

The company's strategy is to maintain a stable dividend distribution. It paid a tax-exempt final dividend of SGD0.20 in 2009 (estimated dividend payout ratio of 22.8%). We expect the company to maintain a dividend payout of at least 20% and do not expect the DPS to fall below SGD0.20 over the next few years barring exceptional losses.

**Auditors' History**

KPMG LLP. Tay Puay Cheng has been the Partner-In-Charge since April 28, 2006.

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