

**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

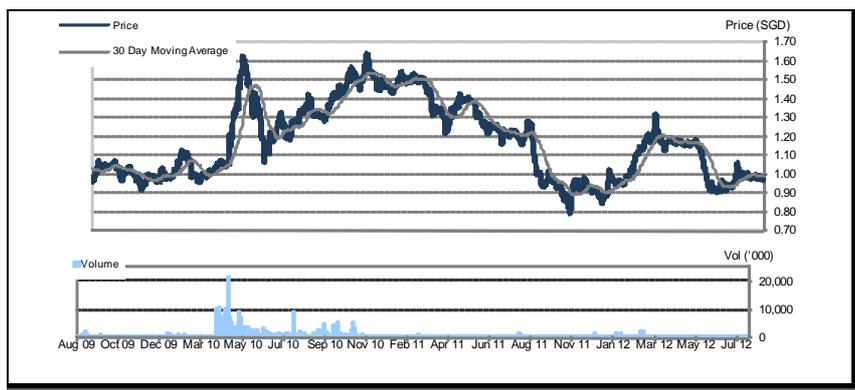
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Key Stock Statistics		
52-week Share Price Range (SGD)		0.84 - 1.33
Avg Vol - 12 months ('000 shares)		219.2
Price Performance (%)	- 1 month	-1.5
	- 3 month	0.0
	- 12 month	0.5
No. of Outstanding Shares (mln)		722.8
Free Float (%)		28.5
Market Cap (SGD mln)		708.4
Enterprise Value (SGD mln)		639.9
Major Shareholders (%)		
China National Aviation Fuel Group Corpo		51.3
BP Investments Asia Ltd		20.2
*Major shareholders stakes exclude treasury shares		

Per Share Data			
FY Dec.	2011	2012E	2013E
Book Value (US cents)	55.52	63.54	73.29
Cash Flow (US cents)	9.4	9.7	11.5
Reported Earnings (US cents)	8.8	9.7	11.5
Dividend (US cents)	1.6	1.6	1.6
Payout Ratio (%)	17.0	16.5	14.3
PER (x)	8.9	8.1	6.9
P/Cash Flow (x)	8.3	8.1	6.8
P/Book Value (x)	1.4	1.2	1.1
Dividend Yield (%)	2.0	2.0	2.1
ROE (%)	18.1	16.1	16.6
Net Gearing (%)	0.0	0.0	0.0

\* 2012-2013 DPS converted into USD at SGD1.26 and SGD1.23, respectively.

## Revenue Surprises to Upside but Costs Hurt Bottomline

- 2012 sees increased revenue but costs eat into profit:** CAO's 2Q12 revenue jumped 50.3% YoY (+27.8% QoQ) but net profit fell 25.2% (-29.6% QoQ). While topline growth surprised us positively with 2Q12 volume trades and average pricing surpassing our projections, increased costs and reduced associate contributions ate into the bottomline. As a result, interim net profit of SGD34.8 mln (-14.5% YoY) was not far off from our estimates, making up 48.4% of our original 2012 forecast. Nonetheless, we opt to fine-tune our 2012 and 2013 net profit forecasts marginally lower by 3.4% and 1.8%, respectively given lower associate contributions and increased administrative costs.
- Slight reduction in our fair value estimate:** Given the reduction in our profit projections and recent peer group price drops, our fair value range for CAO is lowered to SGD1.03-SGD1.18 from SGD1.05-SGD1.20.
- Still looking at relatively decent net profit growth driven by increased supply and trading activity.** The lower oil product prices are expected to cap CAO's earnings in 2012 and we now see earnings growing a more limited 9.5% in 2012 driven mainly by trading and supply volume growth. However, this leads to a projected stronger earnings growth of 18.3% in 2013 on our expectation for firmer oil prices next year. 2Q12 volume of jet fuel supplied and traded jumped 29.1% YoY (+22.9% QoQ), boosted by the preliminary contribution from CAO Hong Kong (CAOHK) and North American Fuel Corp. (NAFCo). Trading of other products jumped four-fold from 2Q11 level (+76.5% QoQ) and strong growth is likely to continue.
- Costs expected to stabilize.** The other key factor to CAO's dampened 2Q12 earnings is the jump in its administrative expense, which is up 91.5% in 1H12 from 1H11 level. The company guides that this should stabilize going forward, albeit at this higher figure. However, full year 2012 EBIT margin should be stable at 0.3% in the absence of one-off charges that hurt 2011 EBIT margin. Otherwise, gross profit margin was within its historical range and at 0.3% is similar to 2Q11 level. This leaves 1H12 gross profit margin at 0.4%, in line with our assumption.
- Associate contribution to remain soft.** 33%-owned SPIA (Shanghai Pudong International Airport Aviation Fuel Supply Company) contribution to CAO fell 31.2% YoY in 2Q12. We anticipate 2H12 contribution to ease further by 2.8% from 1H12 level with jet fuel prices dampened but because of the low base in 2H11 that was hurt by inventory markdowns, full year 2012 contribution from SPIA should improve 2.0% YoY. Nonetheless, this reflects a reduction from our original estimate for 7.0% growth for SPIA.

**Earnings Outlook**
**Revenue Drivers:**

- Total revenue in 2Q12 jumped 50.3% YoY (+27.8% QoQ) driven mainly by increased volumes supplied and traded. We see full year 2012 revenue rising 42.8% to USD12,872.8 mln.
- Supply and trading of jet fuel jumped 29.1% YoY (+22.9% QoQ) in 2Q12 to 2.84 mln tons leaving 1H12 volume up 20.3% YoY. We believe that demand for jet fuel remains positive in China driven by increasing travel and a shift by domestic airlines to focus on more lucrative international routes as high speed trains add competition to domestic routes. However, the jump in supply and trading volumes is also due to the first time inclusion of recently acquired CAO HK and NAFCo activities. For full year 2012, we assume volume growth grows 20.2% and moderates to 14.5% in 2013 on the higher base.
- Average selling/trading price of jet fuel fell 4.1% YoY (-1.3% QoQ) in 2Q12. CAO's jet fuel ASP is holding up better than benchmark indicators since jet fuel has fallen by around 8% internationally. Since global demand is likely to remain sluggish in 3Q12, we forecast CAO's 2H12 jet fuel ASP to fall 6.4% YoY. This leaves a marginal drop of 1.3% in ASP in 2012. Given that the sluggish global demand outlook should continue into 2013, we assume CAO's 2013 ASP to hover around 2012 level.
- Trading of other products – fuel oil and petrochemicals – jumped more than 4.6x YoY (+76.5% QoQ) and we expect this to grow by 3.3x in 2012 and by 66.6% in 2013. While jet fuel supply and trading should continue to make up the lion's share of group revenue, the strong growth in the trading of other products should see the reliance on jet fuel related revenue decline to 76.4% in 2012 from 98.8% in 2011. Increased storage assets are likely to enable CAO to build its non-jet fuel trading network.

**Margin Outlook:**

- Gross profit margins are expected to hover around the 0.4% level (interim gross profit margin is 0.4%, in line with 2011 level) given that the bulk of CAO's jet fuel supply activity is based on fixed dollar terms that are less sensitive to oil price swings.
- Although 2Q12 EBIT margin was pressured by the rise in administrative expenses, we think full year 2012 EBIT margin will be stable at 0.3% in the absence of one-off doubtful debt charges related to MF Global that had dampened 2011 EBIT margin.

**Bottomline:**

- Following the release of 2Q12 results, we adjust our 2012 and 2013 net profit forecasts slightly lower by 3.4% and 1.8%, respectively. This is mainly due to the higher-than-expected administrative expenses and a lower SPIA contribution. We see SPIA contribution to associate income moderating to 2.0% growth in 2012 and 5.0% growth in 2013 given the flattish average selling prices for jet fuel these two years. However, these negative factors are expected to be partly offset by the better-than-expected increase in supply and trading volumes of jet fuel and other products. Hence, earnings growth remains decent at 9.5% in 2012 and 18.3% in 2013.

**Valuation**

We continue to value the company based on relative PER and PBV ratios and the lower fair value range also reflects reduced peer group average ratios following recent drops in peers' share prices. The sector is trading on 12.6x historical PER and Nonetheless, we note relative stability in CAO's share price as its performance has lagged the FSSTI over the past six months, and we think current price levels already reflect key risks to profit performance.

**Earnings Performance**

FY Dec. / USD mln	2Q12	2Q11	% Change
Reported Revenue	3,712.5	2,469.4	50.3
Reported Operating Profit	6.6	6.5	1.7
Depreciation & Amortization	-0.2	-0.1	65.9
Net Interest Income / (Expense)	-1.3	-0.6	>100
Reported Pre-tax Profit	14.9	19.9	-25.3
Reported Net Profit	14.4	19.2	-25.2
Reported Operating Margin (%)	0.2	0.3	-
Reported Pre-tax Margin (%)	0.4	0.8	-
Reported Net Margin (%)	0.4	0.8	-

Source: Company data

**Profit & Loss**

FY Dec. / USD mln	2010	2011	2012E	2013E
Reported Revenue	5,452.6	9,012.0	12,872.8	16,251.3
Reported Operating Profit	18.1	25.7	31.5	42.4
Depreciation & Amortization	-0.4	-0.6	-0.7	-0.7
Net Interest Income / (Expense)	-0.8	-2.5	-4.3	-4.7
Reported Pre-tax Profit	55.7	65.9	72.3	85.4
Effective Tax Rate (%)	1.8	3.8	3.9	3.8
Reported Net Profit	54.7	63.4	69.5	82.2
Reported Operating Margin (%)	0.3	0.3	0.2	0.3
Reported Pre-tax Margin (%)	1.0	0.7	0.6	0.5
Reported Net Margin (%)	1.0	0.7	0.5	0.5

Source: Company data, S&P Equity Research

**Key Financial Performance**

FY Dec.	2010	2011	2012E	2013E
Revenue Growth(%)	50.0	65.3	42.8	26.2
Operating Profit Growth(%)	-13.9	41.9	22.6	34.6
Net Profit Growth(%)	21.0	15.9	9.5	18.3
EPS Growth(%)	21.8	16.2	9.5	18.3
EPS 3-Year CAGR(%)	-31.1	18.6	15.7	14.6

Source: Company data, S&P Equity Research

**Key Fundamentals**

FY Dec.	2008	2009	2010	2011
Asset turnover (x)	9.1	5.8	6.4	8.4
Receivables turnover (x)	0.7	0.4	0.4	0.4
Inventory turnover (x)	NA	191.7	57.5	90.5
Current Ratio (x)	1.8	1.3	1.2	1.2
Quick Ratio (x)	1.8	-1.3	-7.6	-0.4
Net Gearing (%)	0.0	0.0	0.0	0.0
Debt/Capital (%)	0.0	0.0	8.1	7.0
Interest coverage (x)	1,372.1	860.3	450.3	351.0
ROA (%)	6.5	7.2	6.4	6.3
ROE (%)	14.1	15.4	16.7	18.1
Payout ratio (%)	26.2	22.0	20.4	17.0

Source: Company data, S&P Equity Research

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