Company report

Nat Resources & Energy
Oil & Gas
Equity – China

HSBC Global Research

CNOOC Ltd. (883 HK)

Reduce

Target price (HKD)			**9.25**
Share price (HKD)			**10.50**
Upside/Downside (%)			**-11.9**

Dec	2014 a	2015 e	2016 e
HSBC EPS	1.35	0.51	0.89
HSBC PE	6.2	16.4	9.4

Performance	1M	3M	12M
Absolute (%)	-5.7	-0.6	-13.8
Relative^ (%)	-4.5	-5.2	-23.2

28 March 2014

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Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

Reduce: Calm before the storm

- **2014 result stronger than expectations, mainly due to lower taxes and better cost control**
- **However, with a sharp decline in oil prices in 2015, operating results and returns will remain under significant pressure**
- **We establish a Reduce rating (vs. UW under our old rating system); we set a fair value TP of HKD9.25**

CNOOC 2014 net profit was RMB60.2bn, up 6% y-o-y, beating HSBCe and consensus by c15%+. The negative impact of a c.USD9/b drop in realized oil price (USD96/b in 2014 vs. USD104.6 in 2013) was offset by the positive impact from increased production, higher gas prices, lower exploration expenses and lower taxes (mineral resources compensation tax exemption, lower windfall taxes and lower income tax). The 2014 dividend payout ratio declined slightly from 35.6% in 2013to 33.5% in 2014, implying a 5.4% spot yield, though yield drops to 2% on our 2015e forecast.

Cost and budget improvements. All-in cost dropped to USD42.3/b from USD45/b in 2013 mainly due to lower taxes and effect cost controls. The company did expense an RMB4bn provision, and we have deducted RMB5bn impairment from our 2015 forecast.

We cut 2015e earnings by 1%, and raise 2016e 10% after factoring in the negative impact of the impairment, offset by some slight improvement in the cost profile. However on a y-o-y basis, profits are still likely to fall by c.50% as will the dividend.

Outlook. The ROE was flat y-o-y in the mid-teens, and while the management presentation was clearer and more precise than prior events, we believe the company will feel the pressure of lower oil prices in 2015. We forecast 2015e ROE to drop to mid-single digits then move sequentially to 10% and then 12%. We expect the trough returns to weigh on the share price.

We establish a Reduce rating and set a fair value TP at HKD9.25. We use a near-term pure PB-based methodology. We assume the shares will move to 0.8-0.9x book, lower than the 1x PB during the trough cycle in 2008-09, as the company is expected to generate lower ROEs in 2015. We apply a PB multiple of 0.87x (vs. an expected 6% ROE) to 2015e BVPS of HKD10.65. We are 4%/2%/7% above consensus for 2015-17e earnings and our TP is 16% below. **Upside risks:** a sharp oil price recovery, strong production growth, effective cost control, etc.

Index^	HANG SENG INDEX
Index level	24,497
RIC	0883.HK
Bloomberg	883 HK

Source: HSBC

Enterprise value (CNYm)	467733
Free float (%)	35
Market cap (USDm)	60,456
Market cap (HKDm)	468,798

Source: HSBC

Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (CNYm)				
Revenue	274,634	211,419	258,610	305,873
EBITDA	139,201	105,531	135,537	162,654
Depreciation & amortisation	-58,286	-69,571	-75,690	-78,332
Operating profit/EBIT	80,915	35,961	59,847	84,322
Net interest	-3,701	-8,597	-8,857	-11,889
PBT	82,513	31,783	56,202	78,324
HSBC PBT	82,513	31,783	56,202	78,324
Taxation	-22,314	-8,899	-16,299	-22,714
Net profit	60,199	22,884	39,903	55,610
HSBC net profit	60,199	22,884	39,903	55,610
Cash flow summary (CNYm)				
Cash flow from operations	110,508	93,061	117,843	137,108
Capex	-120,200	-89,240	-101,191	-116,488
Cash flow from investment	-90,177	-76,804	-110,475	-125,786
Dividends	-20,321	-8,009	-13,966	-19,464
Change in net debt	4,111	-8,249	6,599	8,142
FCF equity	16,622	-1,076	9,094	11,466
Balance sheet summary (CNYm)				
Intangible fixed assets	20,591	21,465	22,599	24,295
Tangible fixed assets	480,410	496,123	524,578	565,692
Current assets	140,708	120,003	155,018	169,524
Cash & others	14,918	23,167	36,568	29,425
Total assets	662,859	658,741	723,556	781,086
Operating liabilities	126,497	112,152	127,561	144,469
Gross debt	136,563	136,563	156,563	157,563
Net debt	121,645	113,396	119,995	128,138
Shareholders funds	379,610	394,484	420,421	456,568
Invested capital	500,294	502,273	538,066	585,616

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-3.9	-23.0	22.3	18.3
EBITDA	3.1	-24.2	28.4	20.0
Operating profit	3.1	-55.6	66.4	40.9
PBT	2.1	-61.5	76.8	39.4
HSBC EPS	6.6	-62.0	74.4	39.4
Ratios (%)				
Revenue/IC (x)	0.6	0.4	0.5	0.5
ROIC	12.3	5.2	8.2	10.7
ROE	16.7	5.9	9.8	12.7
ROA	9.3	4.0	6.3	8.1
EBITDA margin	50.7	49.9	52.4	53.2
Operating profit margin	29.5	17.0	23.1	27.6
EBITDA/net interest (x)	37.6	12.3	15.3	13.7
Net debt/equity	32.0	28.7	28.5	28.1
Net debt/EBITDA (x)	0.9	1.1	0.9	0.8
CF from operations/net debt	90.8	82.1	98.2	107.0
Per share data (CNY)				
EPS reported (fully diluted)	1.35	0.51	0.89	1.25
HSBC EPS (fully diluted)	1.35	0.51	0.89	1.25
DPS	0.46	0.18	0.31	0.44
Book value	8.50	8.84	9.42	10.23

Key forecast drivers

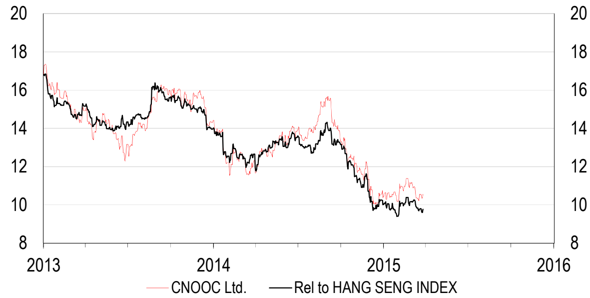
Year to	12/2014a	12/2015e	12/2016e	12/2017e
Total Production (mboe)	433	494	517	522
Brent (USD/b)	99	63	75	90
Realized Oil Price(USD/b)	96	61	73	87
Realized Gas Price (USD/mcf)	6.4	6.8	7.1	7.5
Lifting Costs (USD/b)	12.1	10.9	11.2	11.3

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.7	2.2	1.8	1.6
EV/EBITDA	3.4	4.4	3.5	3.0
EV/IC	1.0	0.9	0.9	0.8
PE*	6.2	16.4	9.4	6.8
P/Book value	1.0	1.0	0.9	0.8
FCF yield (%)	4.7	-0.3	2.6	3.2
Dividend yield (%)	5.4	2.1	3.7	5.2

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

Price relative



Source: HSBC

Note: price at close of 27 Mar 2015

Investment thesis

- Cost improvements are evident, but primarily due to tax and non-cash expenses such as deprecation
- Production economics will remain under pressure as long as oil prices are below USD75/b, which is our forecast case
- As a result we continue to expect that the shares will feel the pressure of low oil prices over the coming quarters

Investment Thesis

We have shifted our valuation basis to a near-term PB-based methodology, assuming the stock will move to 0.8-0.9x book. During the last oil price trough cycle in 2008-09, the China oil majors bottomed at 1x PB, but the companies generated much higher ROEs at that time(in the mid-teens) versus the mid-single digits we expect in 2015.

Long-term asset values overshadowed by near-term risks to earnings and returns. Over the longer term, despite a recent de-rating of the company's valuation and returns due to a combination of a lack of production growth, higher costs and lower international crude prices, CNOOC's longer-term intrinsic value proposition remains intact, in our view, based on our long-term USD95/b oil Brent price assumption. This is consistent with the reserve valuations from third parties such as Wood Mackenzie. But the clear and present danger regarding the underlying operations, cash flow and earnings is the oil price.

2015 outlook

CNOOC provides the market with annual forward guidance each January, and the production outlook was robust. Because the commodity price environment has changed dramatically, there is always the risk that the company will adjust the overall plan at the margin.

The management continued to focus on cost reduction in 2015. They said significant achievement was made in 2014 and led to a 10% reduction in operating cost.

Capex guidance is RMB70-80bn for 2015, which is 26-35% lower than RMB108.3bn in 2014.

2014 result review

CNOOC produced a relative good result helped by rising production, and moderating cost inflation. Many analysts had expected costs to continue rising but concentrated effort by the company to restrain cost inflation had a beneficial impact on the 2014 operating result. Production increased to 433mboe, at the top of the targeted range, and realised oil and gas prices were strong enough during the year to support profitability.

Earnings revisions

We have adjusted our earnings to reflect the trends in place reported in the 2014 result. There are some minor changes to the 2015 cost structure including lower: lifting cost inflation, production taxes, and effective income taxes, but these improvements are largely offset by our new assumption of a flat y-o-y impairment of c.RMB5bn.

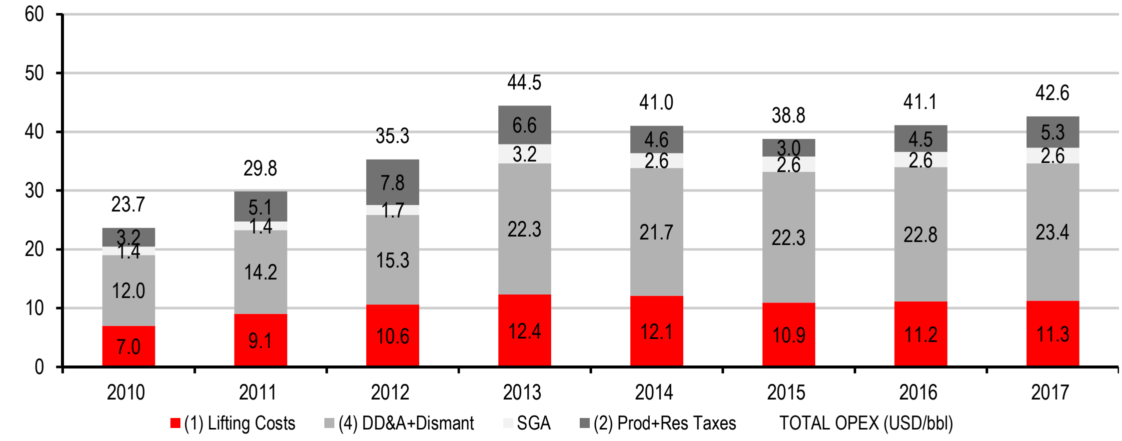
CNOOC earnings forecast changes

	NEW-MAR15					OLD-FEB15				Chg (%)			
	2013	2014	2015e	2016e	2017e	2014e	2015e	2016e	2017e	2014e	2015e	2016e	2017e
Rmb:USD	6.15	6.19	6.32	6.41	6.41	6.2	6.3	6.4	6.4	0%	0%	0%	0%
Brent oil price (USD/b)	108.5	99.5	62.5	75.0	90.0	99.5	62.5	75.0	90.0	0%	0%	0%	0%
Realized oil price (USD/b)	104.6	96.0	60.6	72.8	86.9	95.5	61.3	72.0	86.4	1%	-1%	1%	1%
Realized gas price (USD/mcf)	5.78	6.44	6.76	7.10	7.46	6.6	7.0	7.3	7.7	-3%	-3%	-3%	-3%
CNOOC (mboe)	351	373	425	448	453	363	416	439	444	3%	2%	2%	2%
Nexen (mboe)	61	61	69	69	69	69	69	69	69	-12%	0%	0%	0%
TOTAL PROD (mboe)	412	433	494	517	522	432	485	508	513	0%	2%	2%	2%
TOTAL PROD (mtoe)	56	59	67	71	71	59	66	69	70	0%	2%	2%	2%
Revenue (RMB bn)	285.9	274.6	211.4	258.6	305.9	272.7	212.8	256.3	304.8	1%	-1%	1%	0%
EBIT (RMB bn)	78.5	80.9	36.0	59.8	84.3	73.9	34.9	53.3	77.7	9%	3%	12%	9%
Net Income (RMB bn)	**56.5**	**60.2**	**22.9**	**39.9**	**55.6**	**51.4**	**23.2**	**36.3**	**53.6**	**17%**	**-1%**	**10%**	**4%**
EBIT Margin	27.5%	29.5%	17.0%	23.1%	27.6%	27.1%	16.4%	20.8%	25.5%	9%	4%	11%	8%
Net Income Margin	19.8%	21.9%	10.8%	15.4%	18.2%	18.8%	10.9%	14.1%	17.6%	16%	-1%	9%	3%
EPS (RMB)	**1.26**	**1.35**	**0.51**	**0.89**	**1.25**	**1.15**	**0.52**	**0.81**	**1.20**	**17%**	**-1%**	**10%**	**4%**
DPS (RMB)	0.45	0.46	0.18	0.31	0.44	0.40	0.18	0.28	0.42	13%	-1%	10%	4%
CFPS (RMB)	2.48	2.48	2.08	2.64	3.07	2.54	1.99	2.71	3.20				
EPS Growth YoY (%)	-11%	7%	-62%	74%	39%	-9%	-55%	56%	48%				
CFPS Growth YoY (%)	20%	0%	-16%	27%	16%	2%	-22%	37%	18%				
Payout (%)	36%	34%	35%	35%	35%	35%	35%	35%	35%				
Yield (%)	5.4%	5.4%	2.1%	3.6%	5.0%	4.7%	2.1%	3.2%	4.8%				
ROE (%)	17.3%	16.7%	5.9%	9.8%	12.7%	14.3%	6.1%	9.0%	12.4%				
EPS (HKD)	1.60	1.69	0.63	1.08	1.51	1.44	0.64	0.98	1.45				
DPS (HKD)	0.43	0.44	0.17	0.30	0.42	0.39	0.18	0.27	0.40				
BVPS (HKD)	**8.59**	**9.70**	**10.65**	**10.84**	**11.39**	**9.70**	**10.52**	**10.72**	**11.21**				
WACC (%)	10%												
Current px (HKD)			10.50				10.64						
Target px (HKD)			9.25				9.25				0%		
Up/(downside) %			-12%				-13%						
Current PE(x)	6.5	6.2	16.7	9.7	7.0	7.4	16.7	10.8	7.3				
Current PB(x)	1.22	1.08	0.99	0.97	0.92	1.10	1.01	0.99	0.95				
Current P/CF(x)	3.3	3.4	4.1	3.3	2.8	3.3	4.4	3.2	2.8				
Target PE (x)	5.8	5.5	14.7	8.6	6.1	6.4	14.5	9.4	6.4				
Target PB (x)	1.08	0.95	0.87	0.85	0.81	0.95	0.88	0.86	0.83				
Target PCF (x)	2.9	3.0	3.6	2.9	2.5	2.9	3.8	2.8	2.4				

Source: Company reports, HSBC estimates, Bloomberg

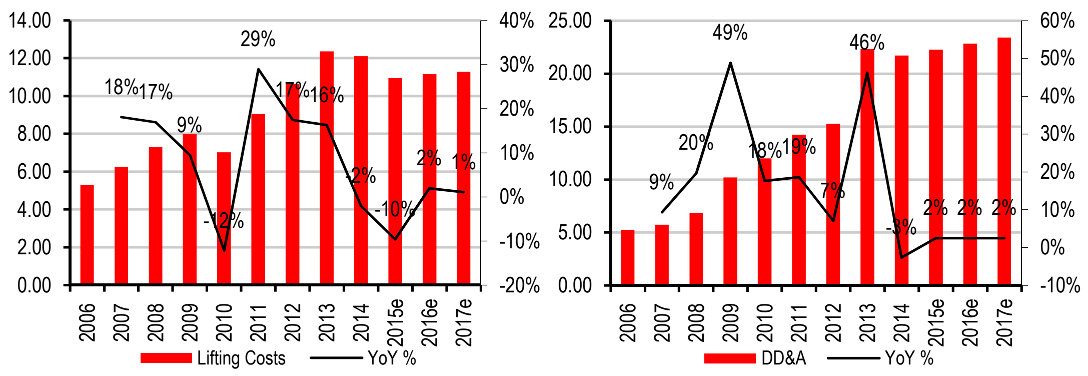
CNOOC costs

All in production costs company style, 2010-2017e (USD/b)



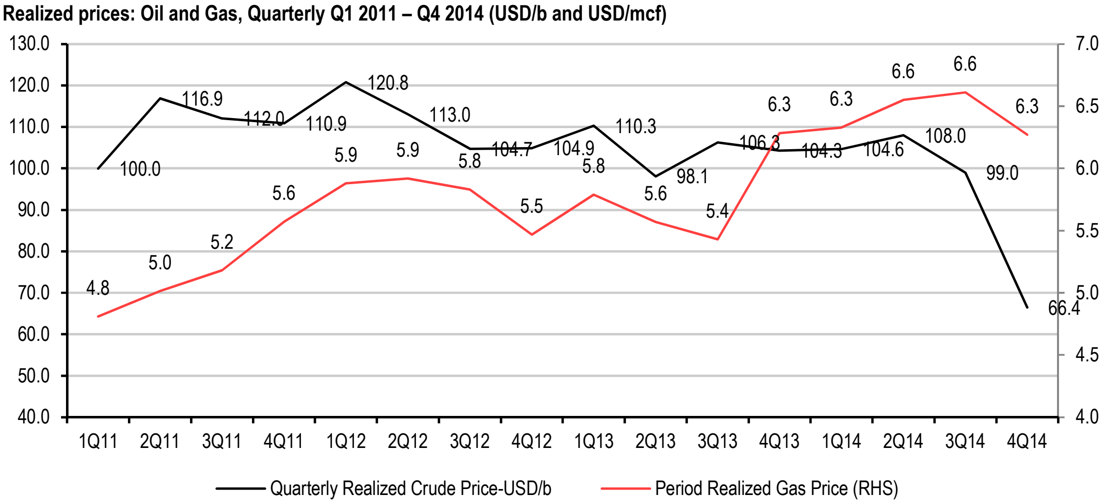
Source: CNOOC, HSBC estimates (differences from disclosed figures are a function of different exchange rates)

Lifting Costs and DDA costs 2006-2017e (USD/b



Source: CNOOC, HSBC estimates

Realized prices: Oil and Gas, Quarterly Q1 2011 – Q4 2014 (USD/b and USD/mcf)



Source: CNOOC, HSBC estimates

Valuation and risks

- We use a book value methodology that makes our target prices less sensitive to small earnings changes
- We think this is the right way to look at the sector currently, although we must watch out for shift in sentiment
- We remain concerned that the 2015 operating environment will remain difficult and that this is not yet fully reflected in share prices

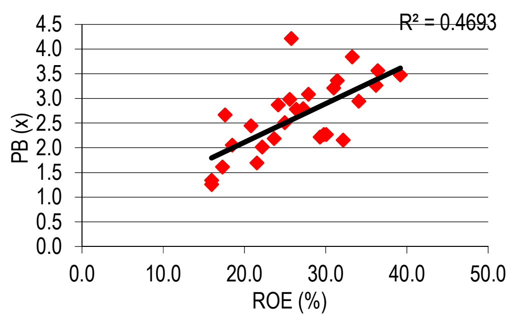
Valuation and risks

We establish a Reduce rating with a fair value target price of HKD9.25. To derive our target price, we use valuation basis of a near-term pure PB-based methodology, assuming the shares will move to 0.8-0.9x book, as we believe that the shares will trade to a lower trough cycle multiple in 2015, than they did in the 2008 trough which was 1x P/B. We apply a PB multiple of 0.87x (versus an expected 6% ROE) to 2015e BVPS of HKD10.65.

Upside risks to our view

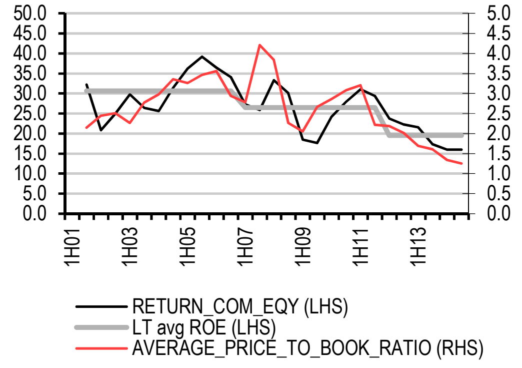
- **Oil prices:** An oil price recovery would boost operating performance and sentiment
- **Operating performance:** 2014 production beating guidance and better-than-expected 2015 production guidance would present a near-term upside risk and any further positive developments in cost control may result in an improved share price performance

CNOOC, Semi-Annual ROE vs. P/B, Scatter, 2000-2014



Source; Bloomberg

CNOOC, Semi-Annual ROE vs. P/B, Time Series, 2000-2014

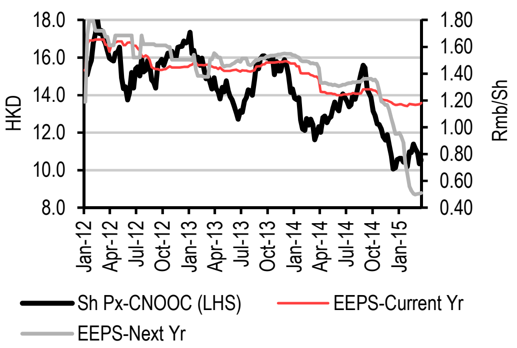


Source; Bloomberg

- **Regulatory risks:** Positive changes in regulatory pricing, tax regime or oversight
- **Global economic risks:** Improved global macro economy and signs of improved oil demand
- **Market risks:** Improved sentiment in financial markets, currencies or interest rates impacting global trade
- **Geopolitical risks:** OPEC and other major oil producing countries' decision to decrease output and hostilities in the Middle East or other geographies may have a significant influence on the oil market

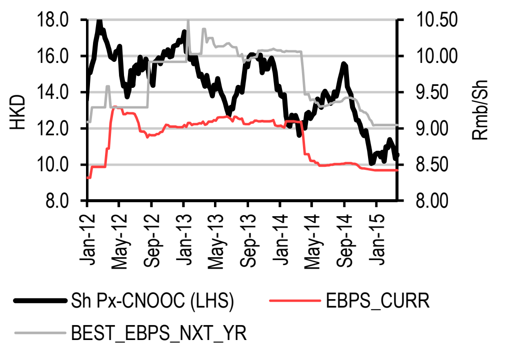
CNOOC key valuation parameters

Share price vs consensus EPS



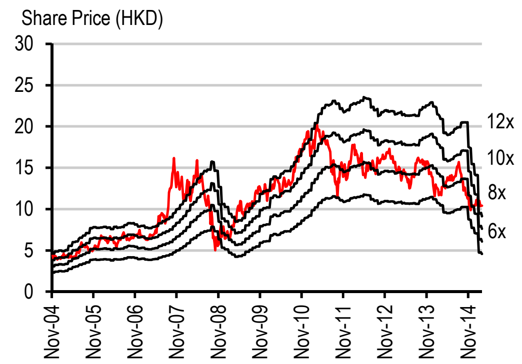
Source: Bloomberg

Share price vs consensus BPS



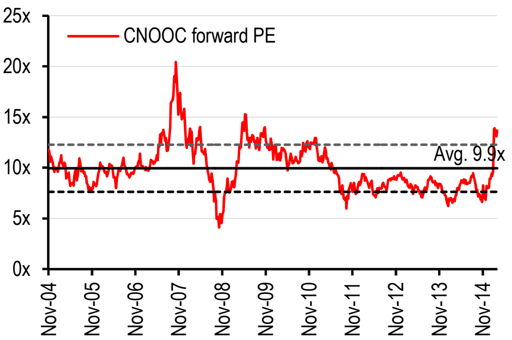
Source: Bloomberg

CNOOC P/E band



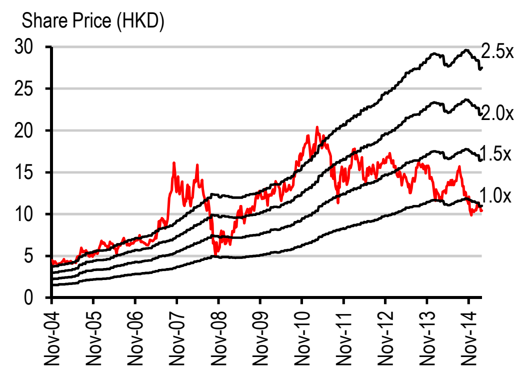
Source: Thomason Reuters Datastream

CNOOC -H long-term P/E



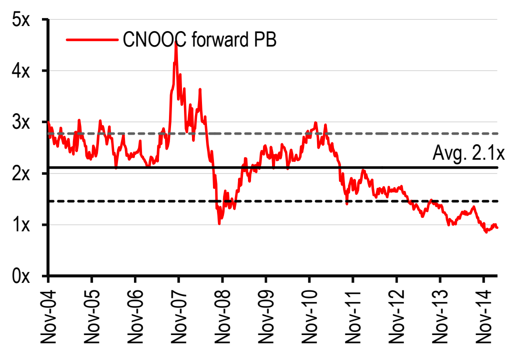
Source: Thomason Reuters Datastream

CNOOC P/B band



Source: Thomason Reuters Datastream

CNOOC long-term P/B



Source: Thomason Reuters Datastream

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Thomas C. Hilboldt, Tingting Si and Hanyu Zhang

Important disclosures

Equities: Stock ratings and basis for financial analysis

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations and that investors utilise various disciplines and investment horizons when making investment decisions. Ratings should not be used or relied on in isolation as investment advice. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations and therefore investors should carefully read the definitions of the ratings used in each research report. Further, investors should carefully read the entire research report and not infer its contents from the rating because research reports contain more complete information concerning the analysts' views and the basis for the rating.

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.

Prior to this date, HSBC's rating structure was applied on the following basis:

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

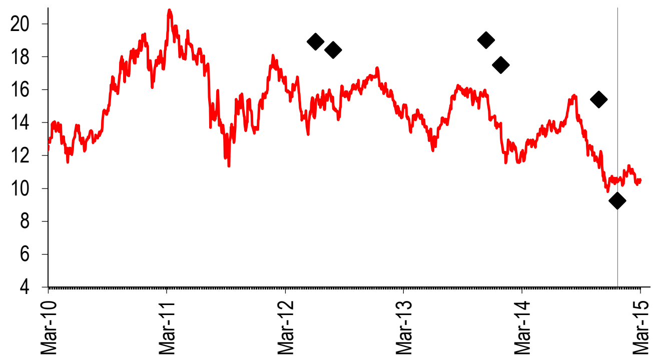
As of 27 March 2015, the distribution of all ratings published is as follows:

Buy	41%	(29% of these provided with Investment Banking Services)
Hold	39%	(28% of these provided with Investment Banking Services)
Sell	20%	(20% 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.

Share price and rating changes for long-term investment opportunities

CNOOC Ltd. (0883.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Underweight	15 January 2015
Target Price	**Value**	**Date**
Price 1	18.90	28 June 2012
Price 2	18.40	21 August 2012
Price 3	19.00	06 December 2013
Price 4	17.50	21 January 2014
Price 5	15.40	19 November 2014
Price 6	9.25	15 January 2015

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CNOOC LTD.	0883.HK	10.50	27-Mar-2015	4, 6, 7, 11

Source: HSBC

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