NOMURA

CNOOC 0883.HK 883 HK

EQUITY: OIL & GAS/CHEMICALS

Weak oil price outweighs marginal cost cuts

Quick Note

Global Markets Research

30 March 2015

Rating Remains	**Neutral**
Target price Remains	HKD 10.10
Closing price 27 March 2015	HKD 10.50

FY14 net profit beat, but low quality; sales and EBIT in line

CNOOC's FY14 net profit grew 6.6% y-y to CNY60.2bn, 10% higher than our estimate and 15% above consensus (Fig. 2, next page). However, we believe this is a low-quality beat, as most of the surprise came from below the operating income line (Fig. 3).

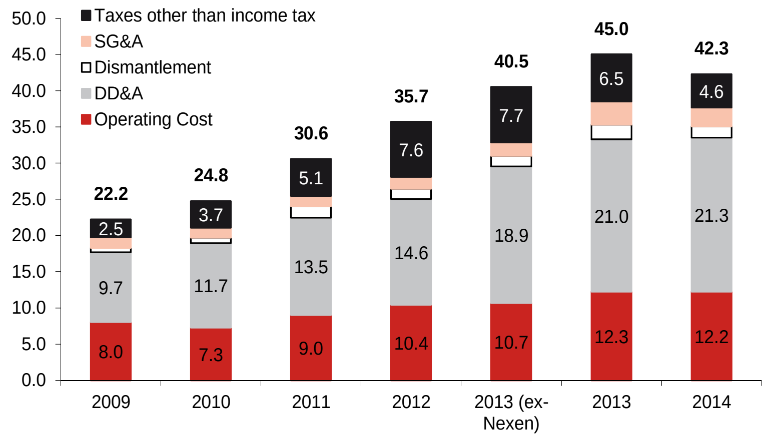
Hence, we maintain our Neutral rating (upgraded from Reduce on 14 Jan. 2015) and HKD10.1 TP, based on a DCF of CNOOC's upstream assets assuming USD80/bbl long-term oil prices. As we expect oversupply concerns to dominate in 1H15F, we believe oil prices will not rally to that level anytime soon, and share price rebounds on the headline earnings beat will likely be short-lived. We see more likely catalysts for PetroChina (857 HK, Buy) and Sinopec (386 HK, Buy) this year, such as higher natural gas exposure (37% and 30% respectively in 2015F, vs. 17% for CNOOC) and potential pipeline/marketing segment restructurings. We also continue to prefer COSL (2883 HK, Buy) as the stock is historically more leveraged to a potential oil price recovery.

Cost controls a good start, but investors may need more convincing

Management highlighted new cost controls taking effect at the analysts' briefing, but we believe the actual improvements have been marginal at best. OPEX and DD&A per barrel were largely unchanged, and while SG&A fell 19% y-y, this was due to higher fees in 2013 related to the Nexen acquisition. If we strip out 2013's acquisition of Nexen's higher-costing overseas assets, CNOOC's all-in costs per barrel and SG&A actually increased by 4% each (Fig. 1).

Fig. 1: CNOOC all-in costs (USD/BOE)

2014's costs still increased if we strip out 2013's Nexen acquisition



Source: Company data

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Summary of results vs. our forecasts and consensus

The company had already stated its production and capex targets in its 2015 Strategy Preview, so most of the results are well within expectations, but we were a bit closer than consensus.

Fig. 2: Summary of results (CNY bn)- earnings beat mainly below EBIT line, due to FX gains and lower tax rate

				Nomura			Consensus			2014 actual vs.	
	2012A	2013A	2014A	2014F	2015F	2016F	2014F	2015F	2016F	Nom.	Cons.
Sales	247.6	285.9	274.6	275.3	183.8	216.1	276.7	206.5	245.9	0%	-1%
EBIT	87.1	78.5	80.9	78.5	36.6	60.7	75.6	39.6	58.6	3%	7%
Net Income	63.7	56.5	60.2	54.7	24.3	41.0	52.3	21.7	38.3	10%	15%
EPS	1.43	1.26	1.35	1.22	0.54	0.92	1.19	0.52	0.87	10%	14%
										Percentage pts.	
Sales growth	2.8%	15.4%	-3.9%	-3.7%	-33.2%	17.6%	-3.2%	-25.4%	19.1%	(0.2)	(0.7)
EBIT growth	-3.8%	-9.9%	3.1%	0.0%	-53.4%	65.7%	-3.8%	-47.6%	48.2%	3.0	6.8
NP growth	-9.3%	-11.4%	6.6%	-3.2%	-55.6%	68.9%	-7.3%	-58.5%	76.4%	9.8	14.0
EPS growth	-9.3%	-11.3%	6.8%	-3.2%	-55.6%	68.9%	-6.2%	-56.3%	67.4%	9.9	13.0
EBIT margin %	35.2%	27.5%	29.5%	28.5%	19.9%	28.1%	27.3%	19.2%	23.8%	0.9	2.2
Net margin %	25.7%	19.8%	21.9%	19.9%	13.2%	19.0%	18.9%	10.5%	15.6%	2.1	3.0

Source: Company data, Nomura estimates, Bloomberg consensus

EBIT climbed 3.1%, vs. our forecast of zero growth and a 3.8% decline for consensus. The CNY2.4bn difference in EBIT vs. our estimates is less than the CNY3.1bn positive surprise below that line, largely stemming from exchange gains and lower income taxes. The effective tax rate dropped to 27% vs. 30% previously, mainly due to recognition of deferred tax assets for their oil sands project in Canada.

Going forward, our estimates are based on USD60/70/80 Brent prices for 2015-17F, which is 11-12% below consensus for the next two years, judging from the disparity in revenue forecasts.

Fig. 3: Summary of surprises below EBIT line

Exchange gains and a 27% effective tax rate (vs. 30% previously) were the major reasons for the beat

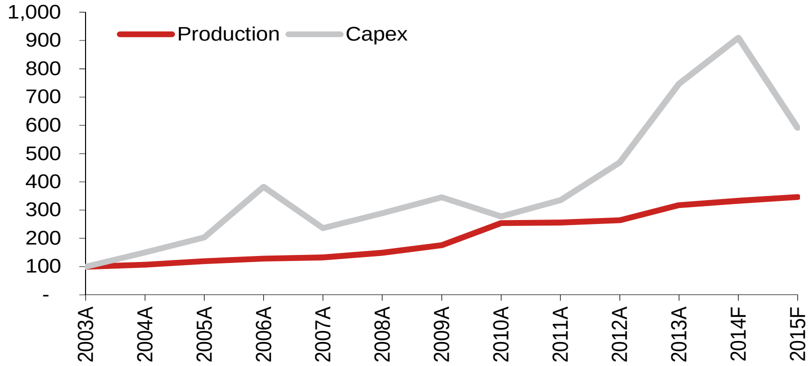
	2014A	2014F	Beat (CNY mn)
Interest income	1,073	1,062	11
Finance costs	(4,774)	(4,987)	213
Exchange gains, net	1,049	-	1,049
Investment income	2,684	2,501	183
Profits from associates	1,006	857	149
Non-operating profit, net	560	320	240
Income tax expense	(22,314)	(23,616)	1,302
Total	**(20,716)**	**(23,863)**	**3,147**

Source: Company data, Nomura estimates

Achieving both production growth and capex cuts is challenging

Given the current low oil prices and relative ease of reducing budgets vs. extracting more oil and gas out of the ground, we maintain our forecast for capex of CNY73bn, about 30-35% less than last year's level (within CNOOC's target range of CNY70-80bn) and for production to grow 4% to 449mmboe this year vs. the stated production target of 475-495 mmboe (10-15% growth). Interestingly, the company guided for much slower production growth of 3-7% next year and 1% in 2017F. We believe this is a way for management to hedge its lower conviction in this year's target.

Fig. 4: CNOOC: capex rose 800% in 2003-14F while production only grew 230%



Source: Company data, Nomura estimates

Since 2003, CNOOC's capex has risen by 8x while production only grew 2.3x (Fig. 4). During that period, there were two years when capex was reduced but production growth was maintained (2007 and 2010). However, in those years, CNOOC had much lower breakeven costs and was not yet saddled with the large DD&A expenses that came with Nexen. Management said in early Feb. that Nexen's higher cost profile from operating in unconventional projects like oil sands and shale makes it one of the primary focus areas for cost-cutting. Until the all-in cost can fall to pre-Nexen levels, we continue to take a wait and see approach on the stock as we expect oil prices to remain choppy but range-bound at USD50-60/bbl for Brent in the next few months.

Fig. 5: New projects in 2015

Project	Location	Expected Startup	Peak Production (boe/d)	Working Interests
Jinzhou 9-3 oil field adjustment	Bohai	Commenced production	12,000	100%
Bozhong 28/34 oil fields adjustment	Bohai	First half	30,000	100%
Kenli 10-1 oil field	Bohai	First half	36,000	100%
Dongfang 1-1 gas field Phase I adjustment	Western South China Sea	Second half	9,000	100%
Weizhou 12-2 oil field joint development	Western South China Sea	Second half	16,000	100%
Weizhou 11-4N oil field Phase II	Western South China Sea	Second half	8,000	100%
Luda 10-1 oil field adjustment	Bohai	Second half	6,000	100%

Source: Company data

Our target valuation of HKD10.1 is based on oil price assumptions of USD60/70/80 for Brent in 2015-17F, maintaining the USD80 assumption adjusted for inflation afterwards.

Fig. 6: Valuation: Our HKD10.1 TP is based on USD80 long-term oil price

Description	USDm
Core NAV	**69,939**
Potential exploration upside 12%	8,393
Combined Core NAV	**78,332**
CNOOC net debt (2014F)	20,094
Equity value	**58,238**
Sharecount	44,646
Equity value/share	**1.3**
Equity value (HKD/share)	**10.1**

Source: Nomura estimates, Wood Mackenzie

Appendix A-1

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
China Oilfield Services	2883 HK	HKD 12.18	27-Mar-2015	Buy	N/A	
Sinopec	386 HK	HKD 6.03	27-Mar-2015	Buy	N/A	A4,A5,A6,A11
PetroChina	857 HK	HKD 8.34	27-Mar-2015	Buy	N/A	
CNOOC	883 HK	HKD 10.50	27-Mar-2015	Neutral	N/A	A13

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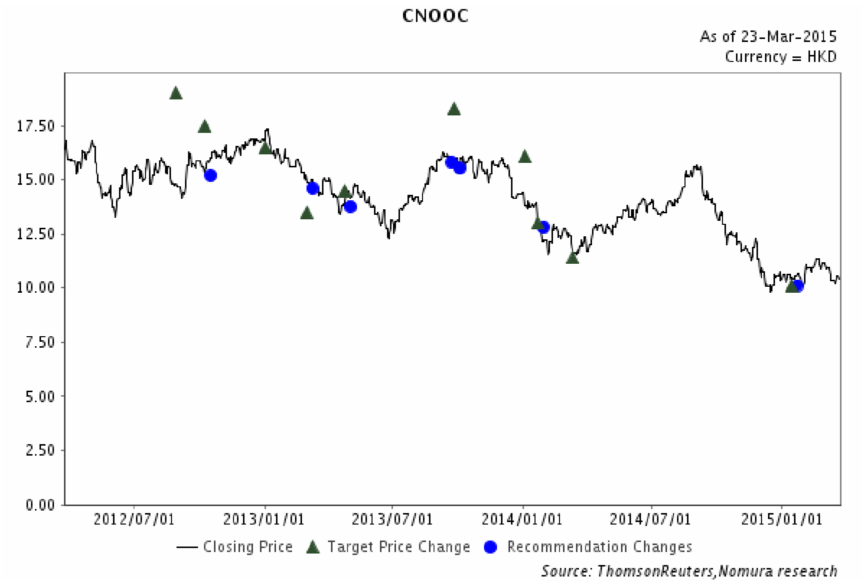
A13 The Nomura Group has a significant financial interest (non-equity) in the issuer.

CNOOC (883 HK) **HKD 10.50 (27-Mar-2015)** Neutral (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
14-Jan-15	Neutral		10.38
14-Jan-15		10.10	10.38
12-Mar-14		11.40	11.68
21-Jan-14	Reduce		13.08
21-Jan-14		13.00	13.08
03-Jan-14		16.10	13.82
25-Sep-13	Buy		15.80
25-Sep-13		18.30	15.80
14-Sep-13	Suspended		16.08
24-Apr-13	Neutral		14.04
24-Apr-13		14.50	14.04
01-Mar-13	Reduce		14.88
01-Mar-13		13.50	14.88
02-Jan-13		16.50	17.30
09-Oct-12	Neutral		15.46
09-Oct-12		17.50	15.46
29-Aug-12		19.00	14.80

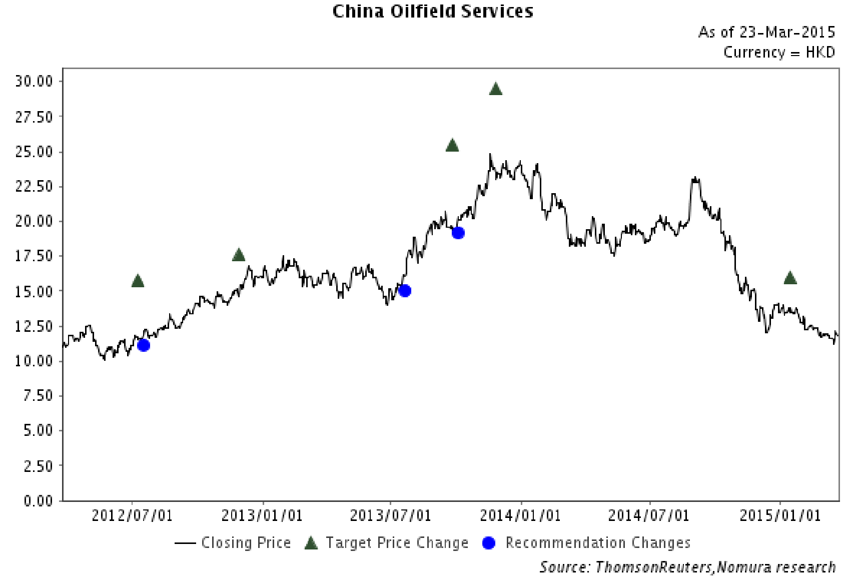
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our HKD10.1 is based on DCF valuation (10% discount rate from 2015F) applying a long-term Brent crude price of USD80. The benchmark index for this stock is MSCI China.

Risks that may impede the achievement of the target price Stronger-than-expected oil price or production growth, faster turnaround in Nexen's operational performance, and new discoveries.

China Oilfield Services (2883 HK) **HKD 12.18 (27-Mar-2015)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
14-Jan-15		16.00	13.50
26-Nov-13		29.50	22.95
25-Sep-13	Buy		19.60
25-Sep-13		25.50	19.60
13-Jul-13	Not Rated		15.44
29-Nov-12		17.60	14.78
09-Jul-12	Buy		11.54
09-Jul-12		15.80	11.54

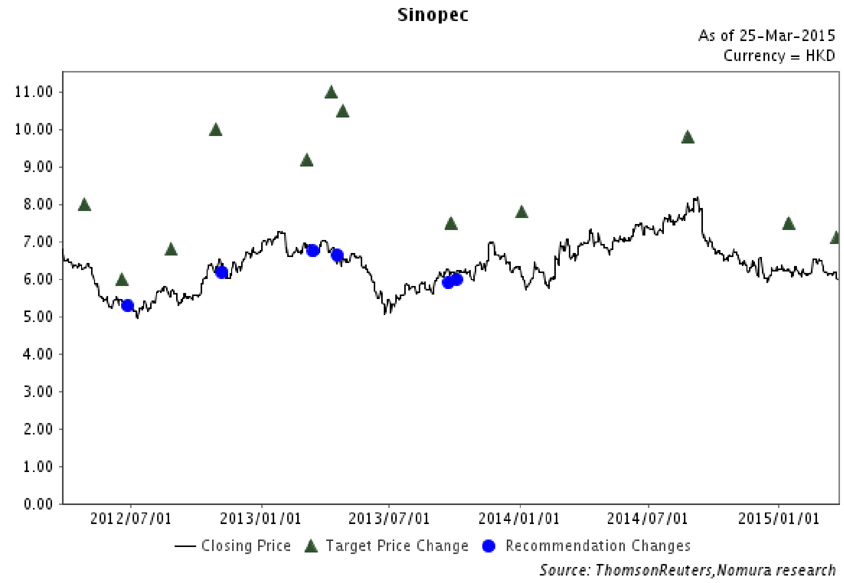
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our HKD16 TP is based on 12x P/E multiple to our 2016F EPS of CNY1.02(HKD1.33), in line with the historical average P/E. The benchmark index for this stock is MSCI China.

Risks that may impede the achievement of the target price Downside risks include 1) faster-than-expected cost increases; 2) greater-than-expected oil price declines; 3) accidents and other safety issues; and 4) delivery delays of new drilling rigs & disappointing progress in deepwater E&P.

Sinopec (386 HK) **HKD 6.03 (27-Mar-2015)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
24-Mar-15		7.10	6.03
14-Jan-15		7.50	6.23
26-Aug-14		9.80	7.98
03-Jan-14		7.80	6.08
25-Sep-13	Buy		6.15
25-Sep-13		7.50	6.15
14-Sep-13	Suspended		6.06
26-Apr-13		10.50	6.515
10-Apr-13	Buy		6.792
10-Apr-13		11.00	6.792
07-Mar-13	Neutral		6.90
07-Mar-13		9.20	6.90
29-Oct-12	Buy		6.346
29-Oct-12		10.00	6.346
27-Aug-12		6.80	5.70
18-Jun-12	Reduce		5.446
18-Jun-12		6.00	5.446
26-Apr-12		8.00	6.30

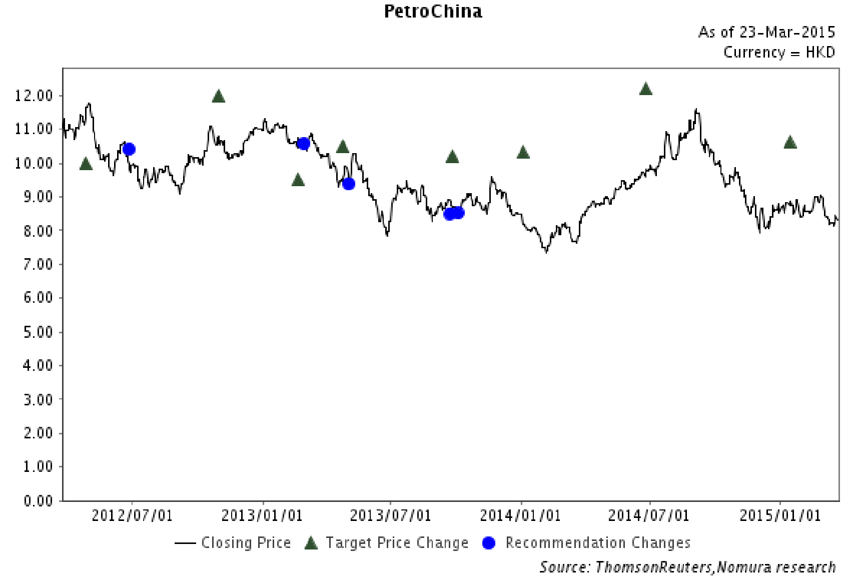
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use sum-of-the-parts (SoTP) valuation to set Sinopec's target price at HKD7.1. For E&P, we use DCF value, using a 10% discount rate, $80 long-term Brent prices, and discounted from Jan-2015. For the refining, marketing and chemical segments, we use normalised EV/EBITDA, applying 6-10x to our FY14-16F average EBITDA forecasts. The benchmark index for this stock is MSCI China.

Risks that may impede the achievement of the target price Downside risks: 1) stalling chemicals and/or oil products growth which could put pressure on prices and margins; 2) disruptions to operations from plant and well-head accidents; and 3) substantial crude price movement that undermines our refining margin assumptions.

PetroChina (857 HK) **HKD 8.34 (27-Mar-2015)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
14-Jan-15		10.60	8.73
25-Jun-14		12.20	9.58
03-Jan-14		10.30	8.20
25-Sep-13	Buy		8.68
25-Sep-13		10.20	8.68
14-Sep-13	Suspended		8.67
24-Apr-13	Neutral		9.56
24-Apr-13		10.50	9.56
20-Feb-13	Reduce		10.74
20-Feb-13		9.50	10.74
30-Oct-12		12.00	10.80
18-Jun-12	Neutral		10.58
26-Apr-12		10.00	11.30

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our TP of HKD10.6 is based on sum-of-the-parts (SoTP) valuation applying a long-term USD80 Brent crude price. For E&P, we use DCF valuation (using a 10% discount rate) based on Wood Mackenzie's field level model. For refining, marketing, chemical and natural gas pipeline segments, we assume normalized EV/EBITDA, applying 6-8x to 2014-16F average EBITDA forecasts. The benchmark index for this stock is MSCI China.

Risks that may impede the achievement of the target price Refining profits could be hurt by NDRC delay of fuel price hikes in response to potential global oil price spikes. More gas import losses due to Russian deal and higher LNG imports. Ongoing corruption probes could result in more negative news headlines for the stock.

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SECTORS

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan prior to 21 October 2013

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