

October 12, 2007

## Colombo Dockyard Limited

## Cash Generator

### Recommendation BUY

Ticker  
DOCK

Share Price\*  
Rs.45.50

Market Cap\*  
Rs.2,965mn

52 Week High  
Rs.49.00

ASPI\*  
2585.60

MPI\*  
3519.14

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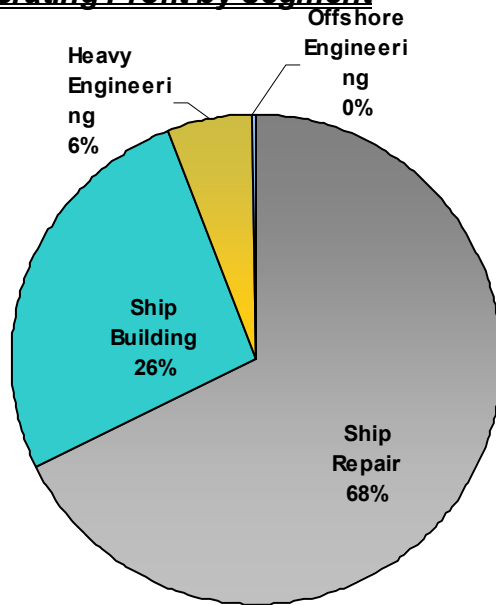
- ◆ Despite our overall negative view on the market, and unlike our view on many of the counters listed on the CSE, we believe Colombo Dockyard is trading at an attractive valuation on a DCF basis and we are initiating coverage on the counter with a Buy recommendation.
- ◆ This year's earnings are likely to fall slightly given a rise in the tax rate and the fact that some major shipbuilding orders are due to be completed only next year, at which time the profits from the contract would be accounted for.
- ◆ Longer term growth will be constrained by the lack of space at the Colombo port, and our projections are conservatively based on an underlying growth in turnover of 10% in line with inflation.
- ◆ We have also not taken into account possible increase in margins given the tight supply situations on shipbuilding and ship repair worldwide, or impact from the relative depreciation of the Sri Lanka rupee against competitor currencies.
- ◆ Though Dock's valuation is also pushed down by the high discount rate, the fact that its current cash flows are very strong, make it less sensitive to the impact of interest rates on its discount rate.
- ◆ We expect Dock to sharply increase its dividend payout from next year onwards, given our projected cash flows.
- ◆ Our FCFE model provides a base case value of Rs.86.72 for DOCK while our DDM valuation provides a value of Rs.56.73.
- ◆ Our 12 month target price for the counter is based on the DDM value of Rs.56.73 and with a Rs.3 dividend also likely in the period, we expect a total return of 31%.

## Company Overview

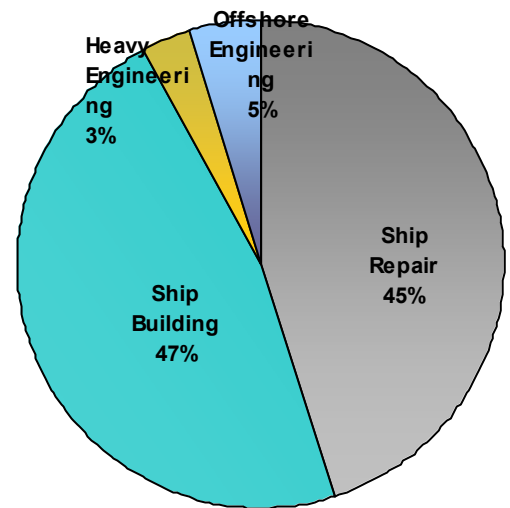
Colombo Dockyard Limited, a subsidiary of Japan's Onomichi Dockyard Co, (from 1993) incorporated in 1974, specializes in Ship Repair, Ship building, Offshore Engineering and Heavy Engineering and provides other services. The parent company which owns 51 percent provides management and technical expertise. With its order book full till mid 2008, we expect a steady stream of revenue. Sri Lanka's only listed ship builder, with a local and international clientele, also bagged the National Chamber of Export Awards' "Most Outstanding Exporter – Runner Up".

The Revenue and Operating Profit per segment is depicted below.

**Operating Profit by segment**



**Revenues by segments**





## **Future Order book Outlook**

The yard which has clients in the Middle East, is also reported to be in talks with an Indian client for further vessels. Greatship(India) Ltd which presently has an order of two 80 tonne bollard pull capacity tugs has made an order for two more tugs, making the value of all four tugs, \$65.5 million. The two new tugs are expected to be delivered in 2009. This will also be the largest vessel built and also the first time a vessel is to be built in the dock. Greatship is a wholly owned subsidiary of one of India's largest private sector shipping companies, the Great Eastern Shipping Company, which provides oil field services to the offshore oil and gas industry.

Colombo Dockyard is also due to build its first passenger ship in its 33 year history, with the Government of India's order for two 89metre, 250 passengers and 100 tons cargo capacity ships, for the first time in local shipbuilding industry, for an amount of \$ 36.6 million. It should also be noted that DOCK is also actively pursuing local ship building contracts. It is looking for three such contracts with the CPC, the Fisheries & Aquatic resources and the Sri Lankan Navy, for which it has tied up with a Croatian yard.

DOCK has also been building and maintaining tugs for the Sri Lanka Ports Authority and for other ports in the island. The company has also captured projects in the Republic of Maldives for heavy engineering. And, the yard delivered the last of a three-tug boat order from a Saudi Arabian customer, A. A. Turki Corporation (ATCO), in the first quarter ended 31.03.07. This quarter also saw Net Profit for Colombo Dockyard shoot up by 50 percent QoQ to reach Rs.200mn, while consolidated revenue rose 16%.



## **Earnings outlook**

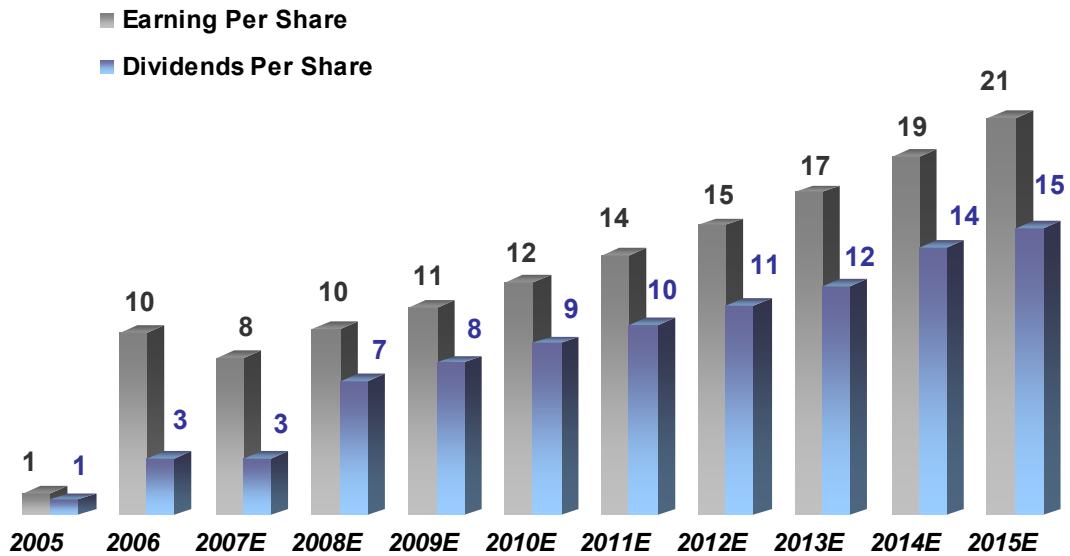
This year's earnings are likely to fall slightly, given a rise in the tax rate (the concessionary tax exemption will continue for more than a decade, while the exemption of income tax on export profits granted by the BOI expires) and as some of their major projects are due to be completed only next year, at which time the profits from the contract would be accounted for.

An important aspect is that DOCK's accounting policy recognizes its profit or loss on a contract only when it completes the project. And so will not see a cash inflow on these until the ships are complete. This is a change, as before the firm had constructed smaller boats which were delivered every few months, recording profits.

Longer term growth will be constrained by the lack of space at the Colombo port, and our projections are based on an underlying growth in turnover of 10% in line with inflation.

We have also not taken into account possible increases in margins given the tight supply situations on shipbuilding and ship repair worldwide, or impact from the relative depreciation of the Sri Lanka rupee against competitor currencies.

In the longer term, as most other foreign owned counters on the CSE have very high dividend payout ratios, we expect DOCK to sharply increase its dividend payout from next year onwards, given our projections on cash flows.



### First half of 2007 results review

For the six months ended 31<sup>st</sup> June 2007 the group increased its revenue by a mere 0.6% compared to the six months ended 30<sup>th</sup> June 2006, to reach Rs.3.6bn. We believe that this meager rise is due to the organization's policy of recognizing revenues once the contract has been completed. Many of the firm's present projects are due to be completed in the following year. With Cost of Sales falling by 2%, the Gross Profit rose by 9.7% to stand at Rs.877mn.

While Other Operating Income, Distribution Costs and Administrative Expenses grew by 25%, 18% and 21% respectively, the Other Operating Expenses shot up by a staggering 1261%, to reach Rs.36mn when compared to Rs.3mn. Profit from Operations improved by 9.4%, to reach Rs.515mn. As Net Finance Cost fell and Taxation rose, Net Profit increased by 8.3%, to stand at Rs.386mn at 30<sup>th</sup> June 2007.

## Valuation

To obtain a view of DOCK valuation we followed two valuation models, namely FCFE and DDM. However our main recommendation is based on DDM valuation which provides the lower valuations out of the two methods.

Our FCFE model provided a base case value of Rs.86.27. We were able to derive this valuation based on 24% cost of capital and terminal growth rate of 10%. The sensitivity of the valuation to our main valuation parameters is presented in the table below.

<b>Sensitivity of FCF valuation</b>						
		<b>Terminal growth rate</b>				
		<b>5%</b>	<b>8%</b>	<b>10%</b>	<b>12%</b>	<b>15%</b>
<i>Ke</i>	<b>18%</b>	105.44	116.65	128.79	149.02	229.97
	<b>20%</b>	94.71	101.91	109.11	119.90	152.28
	<b>22%</b>	86.60	91.45	96.03	102.44	118.92
	<b>24%</b>	80.27	83.66	86.72	90.81	100.34
	<b>25%</b>	77.60	80.47	83.01	86.34	93.83
	<b>30%</b>	67.63	68.97	70.09	71.46	74.20

For a required rate of return of 24% and projected terminal growth rate of 10% the base case valuation we derived for DOCK based on the DDM valuation is Rs.56.73. This valuation showed a relatively some sensitivity to the rate of return with an 8% reduction in cost of equity (24% to 22%) showing an 14% (56.73 to 65.83) rise in the value of the share. The sensitivity analysis of the valuation is shown in the table below.

<b>Sensitivity of DDM valuation</b>						
<i>Ke</i>	<b>Terminal growth rate</b>					
		<b>5.00%</b>	<b>8.00%</b>	<b>10.00%</b>	<b>15.00%</b>	<b>15.00%</b>
<b>18.0%</b>		75.18	86.05	97.82	195.92	
<b>20.0%</b>		64.67	71.65	78.63	120.49	120.49
<b>22.0%</b>		56.71	61.41	65.85	88.04	88.04
<b>24.0%</b>		50.47	53.76	56.73	69.93	69.93
<b>25.0%</b>		47.84	50.61	53.08	63.57	63.57
<b>30.0%</b>		37.96	39.26	40.35	44.33	44.33

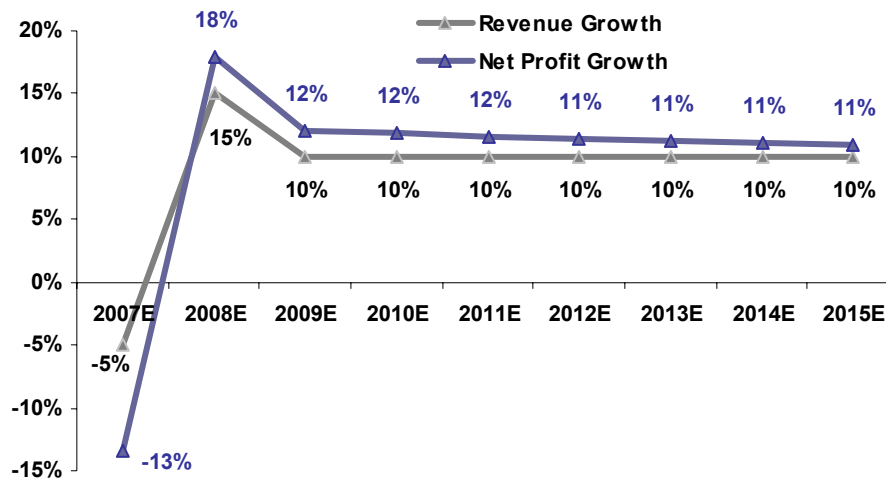
### Risks & Concern

However, whilst Colombo Dockyard has the advantages of being situated in the midst of important shipping lanes, DOCK certain risks.

- ❖ A possible increased perception of security risks at the Colombo Port could lead to clients not being keen on placing orders or the ships/ services being affected.
- ❖ The weakening US\$ against the Euro could be a possible issue for DOCK though the company has generally mitigated the risk. While generally revenues are based in US\$ terms, the much of the major equipment and spares are predominantly Euro based.
- ❖ Colombo Dockyard may also need to expand. They are presently limited to a limited 11 hectares space area, restricting their growth and ability to do more business.
- ❖ Competition headed by China could also be an issue to deal with. And if a global recession were to occur, reducing demand for shipbuilding and ship repair, it could lead to a more competitive market and reduction in overall margins.
- ❖ The absence of government support in the form of subsidies, leads to the firm not being as price competitive when compared to other yards which receive state subsidies. The Indian yards are believed to receive a 30 percent state subsidy helping them compete with DOCK.

The company has also increasingly been sourcing new business in foreign countries, to diversify its business, as the local market tends to fluctuate. With 2006 recording the highest ever financial results, and the Management Plan coming to an end this year, the company is also looking to expand their operations, and maybe move some of the facilities out of the Port of Colombo. The company also foresees an increase in demand for ship building.

Income Statement (Rs.'000)	2005	2006	2007E	2008E	2009E	2010E
Revenue	6,110,472	7,486,406	7,112,086	8,178,899	8,996,788	9,896,467
Net Revenue	6,109,451	7,485,343	7,111,019	8,177,672	8,995,439	9,894,983
YOY%		23%	-5%	15%	10%	10%
Gross Profit	719,008	1,562,913	1,776,955	2,043,498	2,247,848	2,472,632
GM%	12%	21%	25%	25%	25%	25%
Operating Profit	116,095	913,216	831,703	970,712	1,081,499	1,203,122
EBIT%	2%	12%	12%	12%	12%	12%
YOY%		687%	-9%	17%	11%	11%
PBT	62,293	854,873	776,577	915,586	1,026,374	1,147,996
Taxation	12,744	(224,210)	(232,973)	(274,676)	(307,912)	(344,399)
Net Profit	75,037	626,033	543,604	640,910	718,462	803,597
Profit for equity holders	73,196	621,403	538,168	634,501	711,277	795,561
Earnings Growth		0%	-13%	18%	12%	12%
DPS	0.80	3.00	3.00	7.00	8.00	9.00
Divided pay out ratio	68%	31%	36%	72%	73%	74%
Dividend growth rate	0%	275%	0%	133%	14%	13%
EPS (Basic unadjusted)	1.18	9.53	8.26	9.73	10.91	12.21





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