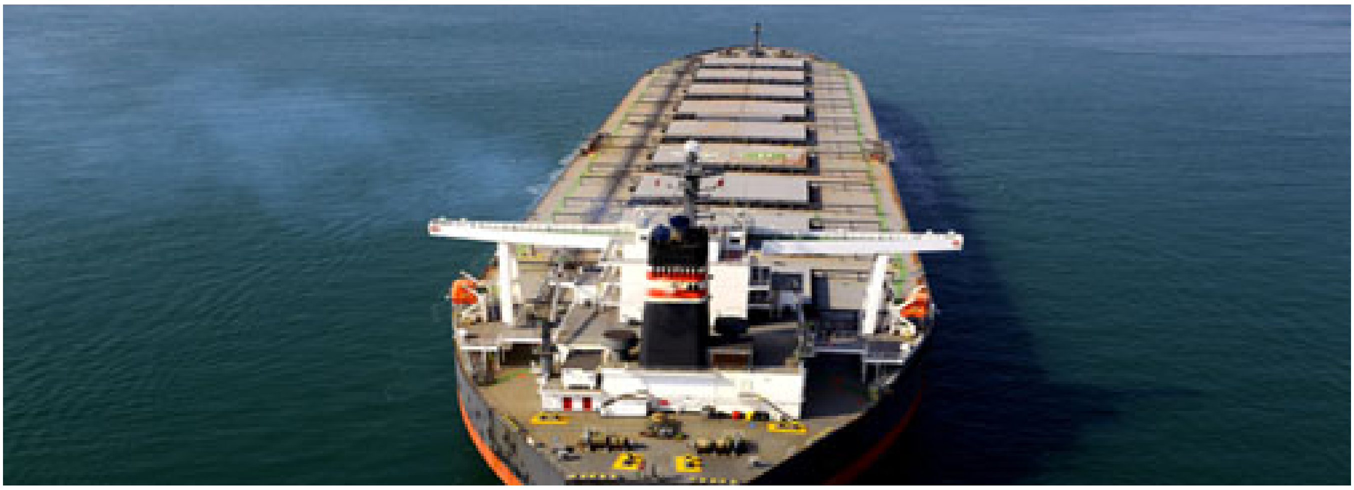

After a year in the pits, the dry-bulk shipping industry looks to have turned a corner. However, the outlook for dry-bulk shipping specialist Mercator Lines (Singapore) is mixed.

Mercator Lines (Singapore) Limited ("Mercator Singapore") is a subsidiary of India's Mercator Group. It operates a fleet of 15 dry-bulk carriers, serving customers mainly in India, China and Indonesia.

Its fleet is relatively young, with an average age of 6 years, compared to the industry's average of 16 years. It was listed on the Singapore Exchange on 14 December 2007 at an IPO price of S$0.76.

Strengths

Riding on the growth of the Indian Power and Chinese Steel Industries

- India's state governments plan to construct more than 10,000 MW of new power stations in the near future. In tonnage terms, these stations would consume about 100 million tons of imported coal per year.
- Mercator Singapore already counts Tata Power, India's largest private power utility

company, as an existing customer.

- By leveraging on Mercator India's onshore logistics capability, Mercator Singapore is in a prime position to capture a bigger slice of the enlarged Indian coal shipping market in the years ahead.
- China, which is also a major market for Mercator Singapore, has seen its steel production expand relentlessly in the past 5 years. In Apr 2010, China's steel output set another new record at 554 million tonnes on the back of strong domestic and export demand.
- Mercator Singapore currently has a 14-year consecutive voyage contract to ship iron ore from Brazil to China and more such contracts could be on the horizon.

Long-term charter strategy

- Mercator Singapore's strategy is to contract its vessels on long-term charters which provide stability in revenues and earnings. Generally, about 70% of its charters are covered by long-term contracts.
- Mercator Singapore's strategy has served it well, with average utilization rates regularly above 99%.
- It also explains how Mercator Singapore was able to remain in the black in 2009 when the Baltic Dry Index plunged to an average of around 2,000. Among its peers, China Cosco, the world's largest operator of dry-bulk ships, sunk into a full-year loss, while Singapore-listed Courage Marine barely turned a profit.

Room to expand fleet

- Mercator Singapore's balance sheet is healthy, despite having invested heavily in new vessels in the past 2 years. Repayments of borrowings have been structured to average at a steady US$24-31 mil annually for the next 5 years. Coupled with the income from long term charters, Mercator Singapore 's free cash flow finally turned positive in FY10.
- Mercator Singapore's net gearing is now just above 0.5. Assuming a maximum net gearing of 1.0, Mercator Singapore has head-room to take on an additional US$150mil in debt to finance 4 to 5 modern dry-bulk Panamax vessels, with a total incremental capacity of about 300,000 dwt (or 25-30% of current fleet size).
- Besides generating additional streams of cash, these new vessels would help Mercator Singapore broaden its customer base and diversify across more geographic segments

Weaknesses/Risk Factors

Looming capacity glut

- Despite the buoyant commodities market, the growth in the capacity of vessels is projected to outstrip increase in demand in 2010 and 2011.
- According to one estimate by shipping consultants and brokers N.Cotzias Shipping Group, overcapacity is expected to reach 37% this year in the Panamax-dry bulk market (which Mercator Singapore is focused on), There are 560 new vessels scheduled to be delivered for the year (against an existing fleet size of 1,530 vessels in 2009) and not all of them would be able to find employment.
- While Mercator Singapore should have no problems chartering out its ships, charter rates are expected to be depressed until the supply-demand balance is restored.
- The slump in rates is already keenly felt by Mercator Singapore. One of its vessels, the Garima Prem, whose current charter was fixed at the tail end of the last shipping boom, has a current daily charter rate of US$60,000 per day until July 2010. However, from August 2010, the charter would be renewed at only a quarter of this amount. The bottom line impact to Mercator Singapore will thus be about negative US$4mil per quarter.
- Taken into context, Mercator Singapore would have to add 3 similar-sized vessels into its fleet, just to mitigate the loss in revenue from the Garima Prem re-contract.

Threat of escalating financing costs

- To arrest a sharp decline in profits, there is little doubt that Mercator Singapore would have to invest in at least 3 vessels in the next one year and finance them with borrowings.

- However, as economic recoveries take root, Mercator Singapore could potentially be caught in a situation where interest rates and financing costs rise more rapidly than charter rates.

Counter-party risk

- First Ship Lease Trust's problems with Groda Shipping over the latter's intention to renege on two charters are a timely reminder that a time charter is only as secure as the willingness and ability of the charterer to honour the contract.
- While piracy risks are insurable and currencies fluctuations can be hedged, counter-party risks are not easily quantifiable or eliminated.
- Fortunately for Mercator Singapore, its charterers are mainly reputable commodity majors and the risks of default, while present, appear to be very low.

Conclusion: Target Price at 35 cents

Mercator Singapore will be a beneficiary as the shipping industry recovers in the medium term. The predictability of its cash flow means it is in a good position to take advantage of low vessel prices to enlarge its fleet.

However, margins in the short term could be depressed by the expiry of a lucrative charter in July 2010. Unless Mercator Singapore significantly enlarges its revenue base by acquiring more ships, its earnings outlook for the financial year 2011 could come under pressure.

At a price of 29 cents (as of 13 May 2010) and assuming management proceeds to acquire vessels, Mercator Singapore's shares currently trade at a forward P/E of about 6.4. At a P/E target of 7, Mercator Singapore's fair value in the next 12 months is 35 cents, which represents a modest upside from the current price. However, if investors are willing to take a longer investing horizon beyond one year, Mercator Singapore is an attractive proposition. **HOLD**.

Price Chart

Flash Player 9 or higher is required to view the chart
Click here to download Flash Player now // View the full EE6 chart at Wikinvest

Key Financial Indicators

Period	FY08	FY09	FY10	FY11F	3Y CAG
Profit & Loss (USD mil)					
Revenue (mil)	146.2	186.1	144.5	149.9	-0.6%
Gross Profit (mil)	NA	NA	NA	NA	
Gross Profit Margin (%)	NA	NA	NA	NA	
Net Profit (mil)	52.2	89.6	41.0	45.0	-11.4%
Net Profit Magin (%)	35.7%	48.2%	28.4%	30.0%	
Cash Flow Statement (USD mil)					
Operating Cash Flow	101.1	111.7	87.8	91.1	
Investing Cash Flow	-298.1	-193.9	-49.7	-150.0	
Financing Cash Flow	324.3	-62.4	-44.7	93.3	
Cash & Equivalents	186.3	41.7	35.1	69.6	
Free Cash Flow	-197.0	-82.2	38.1	-58.9	
As % of Revenue	-134.7%	-44.2%	26.4%	-39.3%	
Balance Sheet (USD mil)					
Assets	625	623	631	760	0.5%
Current	233.6	60.8	52.5	60.0	
Non-current	391.1	561.9	578.6	699.6	
Liabilities	365	283	260	383	-15.7%
Current	76.5	42.0	46.6	50.0	
Non-current	289.0	241.2	213.3	333.3	
Equity	259.3	339.6	371.3	376.4	19.7%
Net Cash (or Debt)	-82.3	-230.0	-208.3	-328.3	
Financial Ratios					
Net Debt/Equity	0.32	0.68	0.56	0.87	
Return on Equity (excl m/i)	20.1%	26.4%	11.0%	12.0%	
Return on Assets (excl m/i)	8.4%	14.4%	6.5%	5.9%	
Stock Fundamentals					
Share price (SG cents)			29.0	35.0	
Shares outstanding (mil)			1,248.6	1,248.6	
Market capitalization (S$ mil)			362	437	
Earnings per share - basic (SG cents)			4.53	4.98	
Earnings per share - diluted (SG cents)			4.53	4.98	
Price/Earnings - basic (annualised)			6.4	7.0	
Price/Earnings - diluted (annualised)			6.4	7.0	
NAV per share -basic (SG cents)			41.1	41.7	
NAV per share -diluted (SG cents)			41.1	41.7	
Net cash per share - diluted (SG cents)			-23.1	-36.3	
Price/NAV			0.71	0.84	
Dividends (SG cents)	1.05	1.16	1.16		
Dividend yield (%)			4.7%		

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