

17 February 2017 | Sector Update

## Oil and Gas sector

***Negative (for upstream)  
Positive (for downstream)***

### ***New wave of consolidation ahead***

- **Stable global crude oil price provides visibility for oil and gas service providers to embark on merger and acquisition trail in anticipation of industry rebound**
- **Four key criteria to satisfy for successful M&A are: (i) alignment of assets between merged entities; (ii) increased ability for merged entity to bid for jobs; (iii) acquisition of assets with contracts and ; (iv) improved operational efficiencies**
- **New wave of merger will be vertical integration to expand product and services offering**
- **M&A activity moving forward will be spearheaded by common shareholders**

It has been three years since global crude oil prices staged a dramatic decline in the summer of 2014, declining by more than 50% in six months and subsequently declining to a low of USD27pb early 2016. Although there were persistent calls for consolidation amongst roughly 3,600 PETRONAS license holders across the services industry for many years, it is not until 2Q15 that **Dayang Enterprise Berhad (NEUTRAL; TP: RM0.95)** officially increased its stake in Perdana Petroleum Berhad which triggered a mandatory general offer (MGO).

Prior to the MGO, Perdana Petroleum has been supporting Dayang Enterprise in providing offshore support vessels (OSV) crucial for hook-up and commissioning works. The acquisition of Perdana Petroleum by Dayang Enterprise can be seen as a strategic tie-up where the latter is a market leader in offshore hook-up and commissioning works, supported by high grade vessels provided by the former.

The more recent proposal to consolidate the industry is between **UMW Oil and Gas (unrated), Icon Offshore (unrated)** and Orkim Sdn. Bhd. This merger will create an integrated service provider consisting a drilling rig owner/operator, offshore support vessel owner/operator and clean petroleum product marine transportation vessel owner/operator. Besides the operational synergies which can be achieved in a merger, we are of the opinion that this strategic merger will benefit the merged entity in the future as it will be able to offer more integrated solutions to its clients.

### **Rationale**

There are four key areas which must be satisfied should any oil and gas service providers choose to embark on the merger and acquisition trail:

#### **1. Alignment of assets between merged entities**

The various assets which are brought together in a merger must be able to complement each other. Gone are the days where companies of similar assets consolidate to form a larger entity within the same space (horizontal integration). For the case of Dayang Enterprise and Perdana Petroleum, Dayang was already utilising Perdana's vessel for its Pan Malaysia hook-up and commissioning campaign and acquiring Perdana would provide Dayang with an uninterrupted utilisation of a fleet of OSVs. In the case of UMW Oil and Gas and Icon Offshore, the proposed merged entity will technically be able to offer its jack-up rigs along with two or three offshore support vessels to its clients. This value-added 'combo-package' will increase the chance of tender success while helping the client to reduce their cost of operations.

## **2. Increased ability for merged entity to bid for jobs**

Studying the local job tender landscape by Petronas and its production sharing partners, most large jobs up for tender are in the form of integrated contracts, where bidders will need to display the ability to undertake multiple tasks required in the package. This can be achieved via forming an alliance with technology partners, acquisition of specific talents or from the procurement of specific assets. For example, the soon-to-be announced maintenance, construction and modification (MCM) package and Pan-Malaysia Transport and Installation (T&I) package from Petronas require contractors to be able to provide various integrated services spanning various segments of the services value chain. The rationale for awarding integrated contracts is for Petronas to have better operational control over the vendors and to reduce operational inefficiencies.

## **3. Acquisition of assets with contracts**

Apart from acquiring companies with good assets to form a larger integrated entity, oil and gas service providers considering the M&A trail must ensure that the assets have cash generating abilities as well, or rather still have the potential to generate revenue in the near term. Again, with the case of the UMW Oil & Gas, Icon Offshore and Orkim Sdn. Bhd, half of UMW Oil & Gas rigs are chartered, the utilisation rate for Icon's OSV is roughly at industry level of 55% and Orkim has long term contracts with Petronas and Shell until year 2021.

## **4. Improved operational efficiencies**

Last but certainly not the least, every merger and acquisition must be able to enhance the merged entity's balance sheet and to improve its operational efficiencies. For the case of Dayang Enterprise and Perdana Petroleum, it is proven that after more than one year after the acquisition, Dayang has managed to restructure Perdana's debts, realigned its fleet of vessels according to current market demand (utilisation rate in excess of 60%), reducing wastages (cancelling the 500-men work barge ordered from Nam Cheong Ltd.) and successfully right-sizing Perdana's workforce. We believe that with the merger of UMW Oil & Gas, Icon Offshore and Orkim, the merged entity would also be able to better restructure its debts, deploy its assets more efficiently, increase its operational scalability and to expand its businesses into new geographical areas.

## **Recommendation**

**Vertical integration moving forward.** In the near to medium term, we believe that more local oil and gas service providers will be considering and will even be in the midst of consolidating their businesses. Vertical integration would be the most likely possibility as different companies involved in different areas of the value chain will look into possible business synergies and business collaborations.

For the past three years since the decline in crude oil prices and slowdown in offshore activity levels, local oil and gas service providers have been rather successful in right-sizing their workforce and rationalising their operating expenses. The next step now is to form larger business entities to bid for larger integrated jobs regionally and globally.

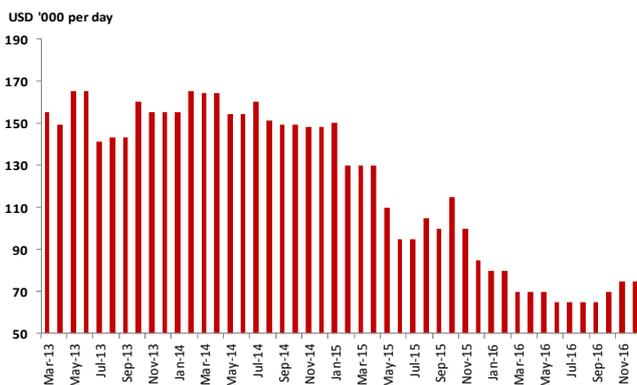
**International capex rising.** Capital expenditure by oil majors are seen to rise in 2017 after three years of being in the lull. According to consensus data gathered, capital expenditure by global integrated exploration and production oil majors is expected to increase by +4.3%yoy in 2017 while North American independent exploration and production companies are expected to increase their capex by more than a third this year. Increase in capex indicates bullishness on the sector and on global crude oil prices. Service providers are also seen positioning themselves in preparation for an increase in demand for offshore services and to also participate in prospective job tenders. Regionally, demand for OSV and drilling assets remain strongest in Indonesia as the government continues to push for developmental drilling in 2017.

**Current round of consolidation to be spearheaded by common shareholders.** We believe that the current round of consolidation will be between oil and gas service providers companies with common major shareholders keen to rationalise their exposure in oil and gas sector while trying to increase their returns on investment. In addition, companies which are more susceptible to consolidation are companies with in-demand proprietary technology and possess a stable of robust assets with moderate utilisation rates. Table 1 details various oil and gas service providers with common shareholders.

**Matter of national agenda.** Moving forward, the creation of larger integrated oil and gas service providers capable of venturing into the global markets is a matter of national importance. The creation of **SapuraKencana Petroleum Berhad (NEUTRAL; TP: RM1.71)** in 2QFY12 paved the way for the country's largest listed integrated service provider with businesses across the globe, not just relying on local Petronas-related contracts. We are hopeful that the new merged entity between UMW Oil & Gas, Icon Offshore and Orkim Sdn Bhd will mimic the success of SapuraKencana in creating a larger global footprint in the oil and gas services realm.

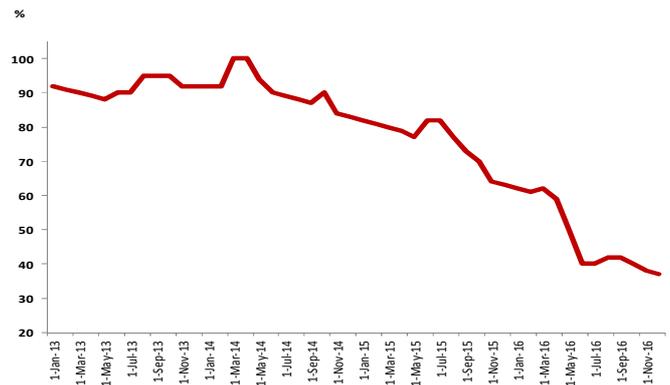


**Figure 1: Southeast Asia Jackup 361-400IC Average Day Rates (USD per day)**



Source: IHS, Rigzone, MIDFR

**Figure 2: Southeast Asia Jackup 361-400IC Contracted Utilisation rates (%)**



Source: IHS, Rigzone, MIDFR

**Figure 3: Southeast Asia rig count table**

	2nd Week February 2017	1st Week February 2017	Jan-17	Feb-16
Total Supply	89	88	89	97
Marketed Supply	75	75	75	87
Marketed Contracted	38	36	35	46
Marketed Utilisation (%)	50.7	48	46.7	52.9

Source: IHS, Rigzone, MIDFR

**Figure 4: Worldwide rig count table**

	2nd Week February 2017	1st Week February 2017	Jan-17	Feb-16
Total Supply	823	828	829	849
Marketed Supply	674	678	679	741
Marketed Contracted	459	458	458	558
Marketed Utilisation (%)	68.1	67.6	67.5	75.3

Source: IHS, Rigzone, MIDFR

\*Include all jackups, semi-submersibles and drillships

\*\*Marketed contracted reflects all marketed rigs that have a contract in place

**Table 1: Listed Oil and Gas companies on Bursa Malaysia with notable shareholders**

Notable shareholders	Companies	Main business
Employee Provident Fund	Bumi Armada	FPSO
	Coastal Contracts	Vessel
	Dialog Group	Tank Farms, Process Equipment
	Favelle Favco	Offshore And Tower Crane
	Gas Malaysia	Gas Supply
	Hibiscus Petroleum	Oil Producer
	Malaysia Marine And Heavy Engineering	Fabricator And Marine
	MISC	Shipping
	Pantech Group	Steel Fabricator
	Perisai Petroleum	Vessel
	Petronas Chemicals	Chemicals
	Petronas Dagangan	Retail Fuel
	Petronas Gas	Gas Supply
	Sapurakencana	Integrated Services
	Uzma	Offshore Service And Chemicals
Permodalan Nasional Berhad and its associated funds	Yinson	FPSO
	Petronas Dagangan	Retail Fuel
	Bumi Armada	FPSO
	Misc	Shipping
	Petronas Chemicals	Chemicals
	Petronas Gas	Gas Supply
	Sapurakencana	Integrated Services
	Malaysia Marine And Heavy Engineering	Fabricator And Marine
Tabung Haji	Wah Seong Corp	Pipe Coating And Industrial
	Alam Maritim	Vessel
	Bumi Armada	FPSO
	Dayang Enterprise	Integrated Services
	Dialog Group	Tank Farms, Process Equipment
	Gas Malaysia	Gas Supply
	Malaysia Marine And Heavy Engineering	Fabricator And Marine
	Pantech Group	Steel Fabricator
	Reach Energy	Oil Producer
	TH Heavy Engineering	Fabricator
	Uzma	Offshore Service And Chemicals
	Wah Seong Corp	Pipe Coating And Industrial

Continue below

Koperasi Permodalan Felda	Dayang Enterprise	Integrated Services
	Gas Malaysia	Gas Supply
	Pantech Group	Steel Fabricator
Kumpulan Wang Persaraan Diperbadankan	Barakah Offshore	Offshore Services
	Bumi Armada	FPSO
	Coastal Contracts	Vessel
	Dayang Enterprise	Integrated Services
	Sapurakencana	Integrated Services
	MISC	Shipping
	Deleum	Turbine And Offshore Services
	Petronas Dagangan	Retail Fuel
	Uzma	Offshore Services And Chemicals
	Petronas Gas	Gas Supply
	Petronas Chemicals	Chemicals
	Reach Energy	Oil Producer
	Perisai Petroleum	Vessel
	Favelle Favco	Offshore And Tower Crane
	Gas Malaysia	Gas Supply
Dialog Group	Tank Farms, Process Equipment	
Lembaga Tabung Angkatan Tentera	Dayang Enterprise	Integrated Services
	Malaysia Marine And Heavy Engineering	Fabricator And Marine
	Wah Seong Corp	Pipe Coating And Industrial
Petroleum Nasional Berhad	MISC	Shipping

Source: MIDFR, Bloomberg, Bursa Malaysia, Companies

**Table 2: Recently announced/completed oil and gas companies deals in 2017**

Deal Type	Target Name	Acquirer		Seller		Announced total value (RMm)	Deal Status	Announced date	Completion / Termination date
		Name	Country	Name	Country				
M&A	Asian Geos Sdn bhd	Java Offshore	Indonesia	Gardline Geosciences Ltd, Helms Geomarine Sdn Bhd	U.K., Malaysia	n.a.	Completed	23-Jan-17	23-Jan-17
JV	Galactic Maritime Malaysia Sdn Bhd	INIX Technologies Holdings Bhd	Malaysia	n.a.	n.a.	4.6	Pending	19-Jan-17	30-Jun-17
M&A	Icon Offshore Bhd	UMW Oil & Gas Corp Bhd	Malaysia	n.a.	n.a.	944.3	Pending	19-Jan-17	-
M&A	Icon Offshore Bhd	UMW Oil & Gas Corp Bhd	Malaysia	Ekuiti Nasional Bhd	Malaysia	248.9	Pending	19-Jan-17	-
M&A	MMC Oil & Gas Engineering Sdn Bhd	Melati Pertiwi Sdn Bhd	Malaysia	MMC Corp Bhd	Malaysia	50	Pending	19-Jan-17	30-Jun-17
M&A	Orkim Sdn Bhd	UMW Oil & Gas Corp Bhd	Malaysia	Ekuiti Nasional Bhd	Malaysia	472.7	Pending	19-Jan-17	-
M&A	Tecnic Group BHD	Private Investor, Rohas-Euco Holdings Sdn Bhd	Malaysia	n.a.	n.a.	2.9	Pending	12-Jan-17	-

Source: MIDFR, Bloomberg, Bursa Malaysia, Companies

## DAILY PRICE CHART

### Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

### West Texas Intermediate crude oil price (CL1)



Source: Bloomberg, MIDFR

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### MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

#### STOCK RECOMMENDATIONS

BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

#### SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.