25 April 2014 | Sector update

Oil & Gas sector

Mergers & acquisitions in the O&G scene – what's next?

Reiterate **POSITIVE**

WTI Crude: USD101.8pb

- **Market observers expecting approximately RM8b* worth of mergers and acquisitions (M&A) in 2014**
- **Challenging and evolving environment will spur M&As**
- **Key forces driving M&As are cost containment and competition elimination**
- **Expecting more possible M&As amongst Bursa-listed O&G entities**
- **Maintain POSITIVE on local oil and gas sector**

Cost containment & human capital issues. Moving forward, cost containment will be pivotal as raw material price (primarily steel) becomes more volatile while labour costs continue to be on the rise. Local O&G service providers have indicated their concerns on labour shortage and increasing wages in the industry. In addition, industry players have noted that the trend in the industry is towards "buying" rather than "building" talents to fill in vacancies. In a survey conducted by Mercer in 2013, 68% of O&G companies are more inclined on 'buying' talents rather than 'building' existing employees. This we believe, is one of the basis for driving M&As in the O&G sector. Mercer also noted that the services and drilling segment has the highest turnover across the entire O&G value chain.

The case of Destini Bhd. In March 2014, local aviation maintenance, repair and overhaul company **Destini Bhd** (not rated; TP: RM0.78) completed the acquisition for the entire O&G tubular handling business from Kejuruteraan Samudra Timur Bhd (KST) for RM80m. Purchased together with the business' existing orderbook at that time was the staff (senior and junior) attached to the unit. The key staff and ground crew were made to sign a two-year retention contract with the company.

Synergistic value. Apart from cost and human capital drivers, M&As are undertaken for synergistic values. The most notable case in Malaysia is the RM12b merger between SapuraCrest Petroleum and Kencana Petroleum – SapuraCrest being an installation expert and Kencana being a fabrication and engineering expert. Moving forward, we could possibly see more consolidations between smaller Bursa-listed O&G service providers or private service providers being absorbed into existing listed entities.

MIDFR's Mosaic Theory – The 'Quek' game. In less than 12 months, Tan Sri Quek Leng Chan, along with parties associated with him have acquired substantial stakes in two Bursa-listed oil and gas service providers – **TH Heavy Engineering Bhd** (not rated; TP: RM1.17) and **Alam Maritim Resources Bhd** (not rated). We believe that there could possibly be more acquisitions and possible mergers on the horizon, instigated by Tan Sri Quek and his associates. We have compiled a list (*refer to Table 1*) of possible targets based on these two criteria:

- **Common shareholder.** For both TH Heavy Engineering (THHE) and Alam Maritim Resources, the common shareholder is **Lembaga Tabung Haji**, holding 29.29% and 9.01% (post acquisition) respectively. We believe that there could be possibilities of future M&As involving companies with this common major shareholder.
- **Synergistic values.** Aligned with the government and Petronas' aim of creating globally competitive O&G service providers via M&As, we believe that the next acquisition (should he still be looking at more acquisitions) by Tan Sri Quek could potentially be companies which complements TH Heavy Engineering and Alam Maritim's businesses. Referring to *Chart 1*, we opine that future M&As could be focused around companies operating in the '*Development*' sphere.

**value derived from study conducted by Deloitte Consulting*

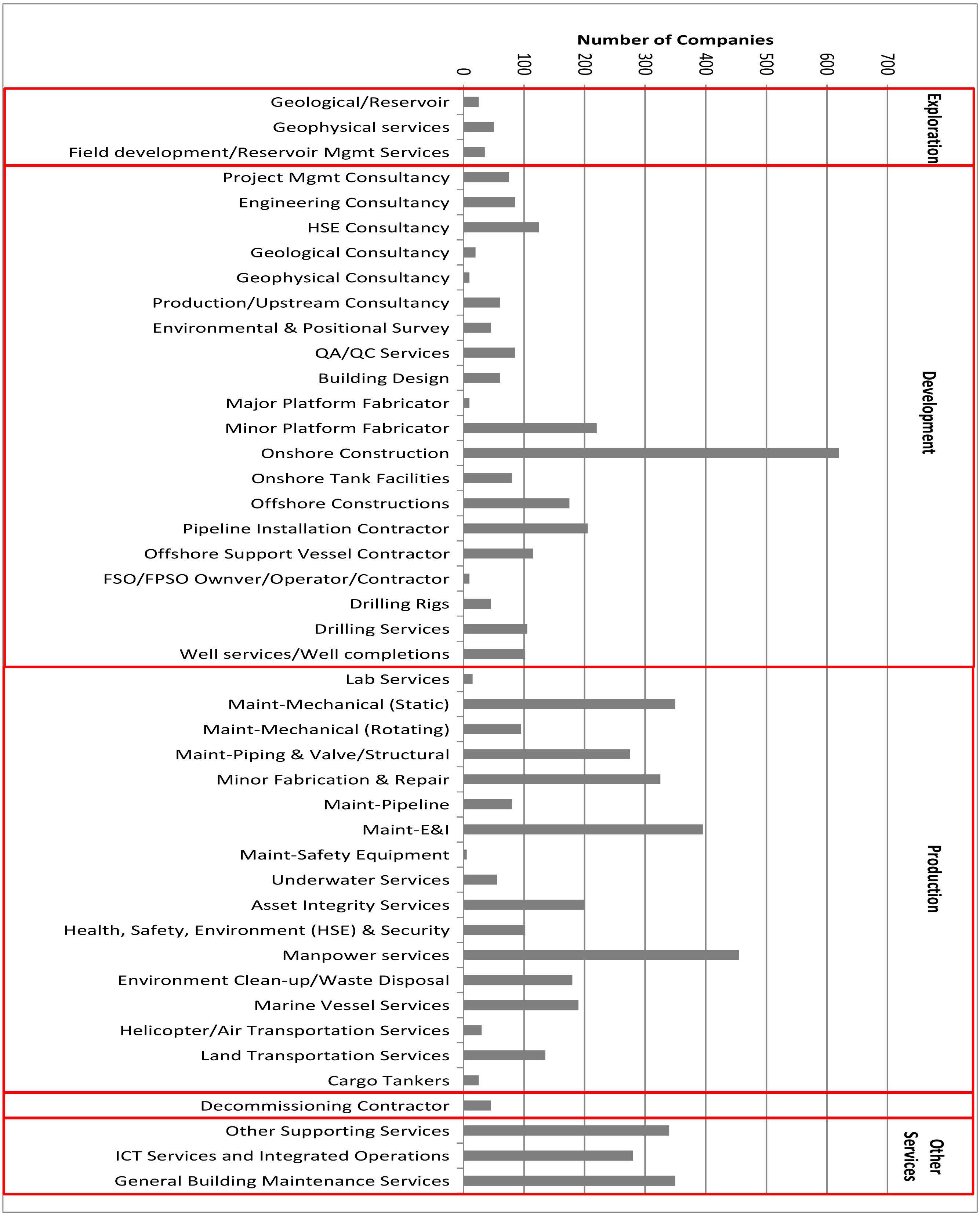
Table 1: MIDFR's Mosaic Theory on possible M&As by Tan Sri Quek Leng Chan and associated parties

Company	Lembaga Tabung Haji's stake (%)	Synergistic values
Malaysia Marine & Heavy Engineering * (Sell; TP: RM2.66)	6.14	▪ Owns second largest fabrication yard in Malaysia – able to complement THHE's yard in Pulau Indah ▪ Ability to secure larger and more complex jobs as partners – leverage on THHE's partnership with McDermott International ▪ Able to provide Alam Maritim with ship repair services
Dayang Enterprise (Buy; TP: RM4.06)	5.01	▪ Alam Maritim is able to complement Dayang's business as it owns various supply and maintenance vessels ▪ Dayang could charter vessels from Alam Maritim at favourable rates or given the right-of-first-use (similar to arrangements done between Dayang and Perdana) ▪ Alam Maritim is also able to support Dayang's hook-up and commissioning works offshore with its other vessels ▪ Acquisition in Dayang provides exposure into Perdana Petroleum (Dayang has 30.9% stake) ▪ Compelling valuations – Forward PER is 14.8x, lower than its 3-year average rolling PER of 15.5x
Perdana Petroleum (not rated)	8.45	▪ Ability to leverage on Dayang's strength in hook-up and commissioning ▪ Improve success rates in tenders due to fleet size and age (new-builts operated by Perdana) ▪ Reduces competition by merging – both Alam Maritim and Perdana have Anchor Handling Tugs & Supply vessels and barges. ▪ Reasonable valuations – Forward PER of 14.8x
Petra Energy (not rated)	9.89	▪ Owns a minor fabrication yard – able to complement THHE. ▪ Owns and operates three accommodation/workbarges and two workboats – reduce competition with Alam Maritim ▪ Gain exposure into process equipment fabrication and design ▪ Petra's oilfield optimization (sub-surface) business could benefit from Alam Maritim's vessels and subsea rovers
Uzma (not rated)	7.51	▪ Uzma's oilfield services and subsea services will complement Alam Maritim's fleet of offshore service vessels ▪ Compelling valuations – Forward PER is 17x, lower than its 3-year average rolling PER of 18.2x
Tanjung Offshore (not rated)	8.00	▪ Synergistic business as Tanjung Offshore owns vessels with almost similar functions with Alam Maritim – a merger would eliminate competition (margin compression) and increase tender success rates ▪ The entry of strategic shareholders could potentially bode well for the company ▪ Oilfield services and other subsea services could add value to Tanjung Offshore's vessels.

** Theoretically possible, but rather unlikely.*

Source: Bloomberg, MIDFR, Company

Chart 1: Oil and gas ecosystem in Malaysia

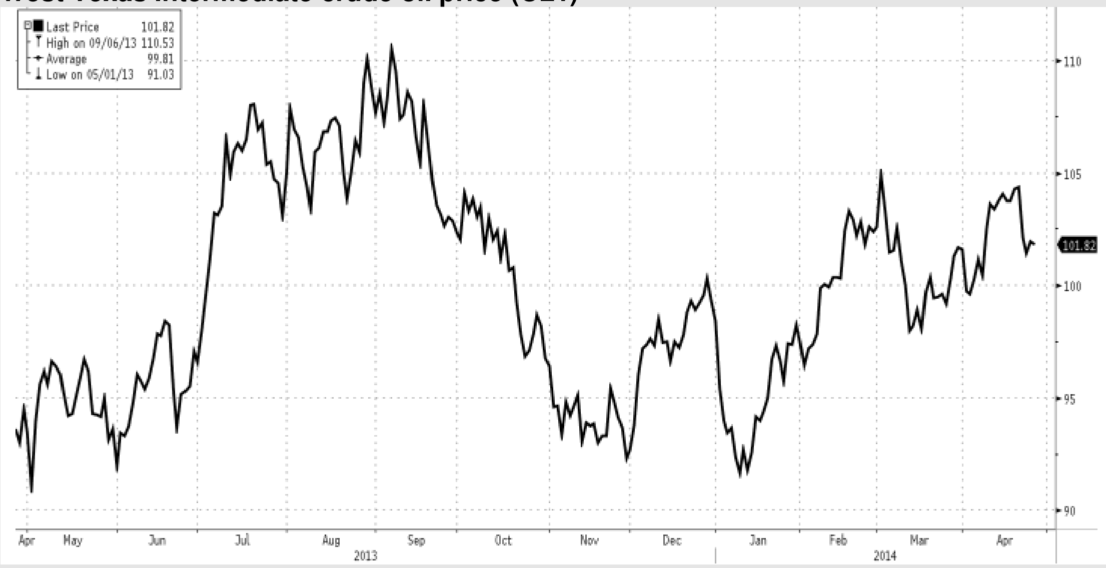


Source: Malaysia Petroleum Resources Corporation, MIDFR

Maintain POSITIVE on sector. Clearly, our mosaic theory for the abovementioned M&As will be subjected to the test of time. Nonetheless, we expect positive sentiment based on potential M&As to continue to spur investors' interests in Bursa-listed O&G service providers. Hence, he continue to reiterate our **POSITIVE** stance on the sector. For the large-cap O&G service providers, we recommend **SapuraKencana** (BUY; TP:RM5.36) and **Bumi Armada** (BUY: TP:RM4.62). As for our small-cap picks, we recommend **Destini Bhd** (Not rated; TP:RM0.78 – recently purchased Kejuruteraan Samudra Timur's oil and gas tubular handling outfit), **Pantech Group Holdings Bhd** (Not rated; TP:RM1.26) and **TH Heavy Engineering Bhd** (Not rated; TP:RM1.17).

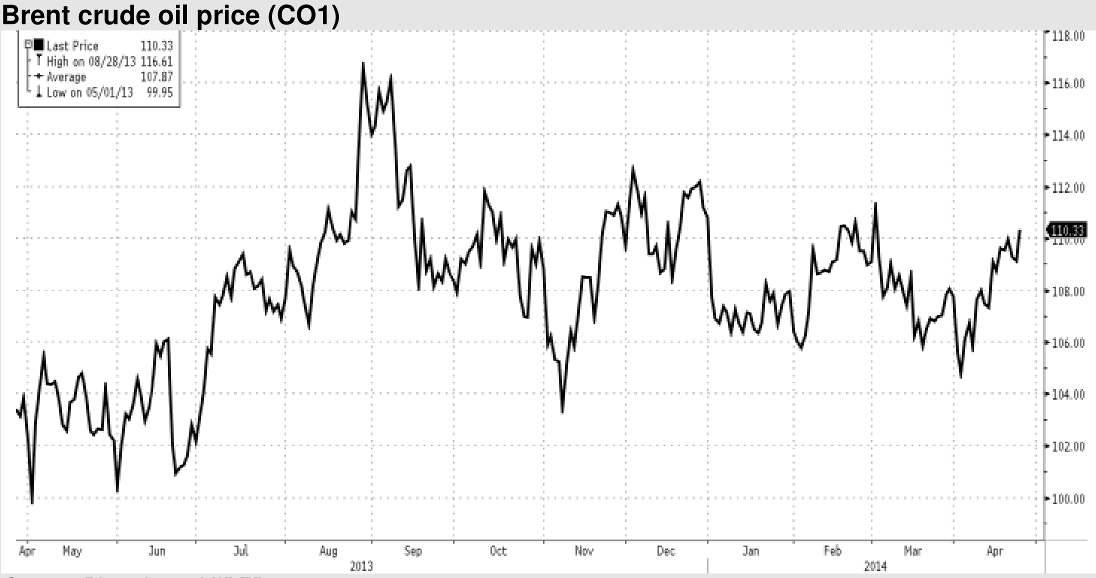
DAILY PRICE CHART

West Texas Intermediate crude oil price (CL1)



Source: Bloomberg, MIDFR

Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* 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 *fall* 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.