Andes Cheng
(852) 2533 3721
andescheng@sbie2capital.com

Muti-disciplinary oilfield services specialist — China Energy Logistics

Anton Oilfield Services (3337 HK, HK$1.46) — Not Rated

Operation model

Background. In the oil and gas exploration and production industry, companies that focus on exploration, extraction and production, refining and distribution contract out their field-related activities to oilfield service providers such as Anton Oilfield Services Group. The company offers drilling of exploration and production wells, well completion, production and maintenance services, which cover all stages of the well's life.

Drilling. Drilling involves penetrating layers of hard rock at depths of 1,000-7,000 meters, inserting well casing and well tubing to serve as a conduit for oil and gas flow.

Well completion. The petroleum producing zones of wells are located in the oil or gas reservoir formation. Once the oil and gas reservoir has been tested and the field determined as ready for commercial development, drilled wells will require well completion to allow for optimal commercial production.

Production. Once wells are completed and surface equipment is in place, commercial oil production is ready to begin. Many oil wells, especially onshore require a mechanical pump on the surface and a downhole pump to pull oil to the surface through a suction process.

Maintenance. Various types of maintenance techniques and water treatment are required for wells to optimize oil production.

Divisions. The company's operations are grouped in four divisions: drilling services, well services, production services and field services.

Drilling division. The division manufactures, sells and installs drill pipes, drill collars and heavyweight drill pipes, well casing and tubing, and provides related value-added services, including drill pipe testing and hard banding welding. The company also offers testing and inspection, hard banding and welding services for drill pipes, heavy-weight drill pipes, drill collars, other drilling tools, welders and jars as well as maintenance services to drilling contractors.

Well services. The group offers high-end fracturing and acidization services, sand control services and well cementing services and targets technically demanding geological conditions such as high-pressure gas wells, deep-zone wells and horizontal well.

- **Well fracturing and acidization** is used in the well completion process to increase the production and recovery rate of oil and gas in reservoirs with relatively tight reservoir rock, by creating or enlarging existing fissures and cracks in the rock to maximize the production rate of oil and gas.
- **Well sand control** is used to prevent sand in the reservoir zone from entering the oil and gas production channel, minimize suspension of production caused by sand accumulation, maximize production and prolong the production life of oil and gas wells.
- **Well cementing** is required to strengthen the well wall to prevent it from collapsing under high pressure. It involves injecting a layer of cement between the well casing and well wall, utilizing specially designed and selected downhole cementing tools, such as tail pipe suspension hangers and packers.

Oil and gas production equipment. The company manufactures production equipment and provides related services to oilfields, focusing on extending the life of machinery used in corrosive and sandy conditions, improving productivity and reducing costs. The products offered include durable and corrosion-resistant couplings, sucker rods and specialized downhole pumps.

Field services. A comprehensive range of on-site services offered to large oil and gas producing areas or bases, which include drill-pipe leasing, coating, mechanical maintenance and ground construction. The group also provides testing, repair, maintenance and coating services for drilling tools and well tubing, as well as hard banding welding services.

Financial aspects

Revenue breakdown. As of end-FY12/06F, well services generated 7.1% of total revenue (1H FY12/07F: 47.5%), drilling services 46.8% (1H FY12/07F: 30.7%), production services 18.9% (1H FY12/07F: 10.2%) and field services 27.2% (1H FY12/07F: 11.6%).

Financial aspects and earnings forecasts. The group's revenue and net earnings increased at a 2-year CAGR of 75.6% and 71.0%, respectively. At end-1H FY12/07F, its net debt and net equity stood at RMB81.5m and RMB345.2m, representing a net gearing ratio of 69.8%. The IPO prospectus put net earnings and fully diluted EPS for FY12/07F at at least RMB110.6m and RMB0.05, respectively. The company raised HK$904.6m by offering 520.0m shares at HK$1.88 each.

Table 1: Financial highlights

	04A	05A	06A	1H 06A	1H 07A
Revenue (RMBm)	80.1	149.2	247.0	38.8	174.0
growth (%)	-	*86.4*	*65.5*	-	*348.5*
Operating profit (RMB m)	26.5	47.9	84.8	2.7	46.9
growth (%)	-	*81.0*	*77.0*	-	*1,624.5*
Net profit (RMB m)	26.2	43.8	76.7	2.2	42.4
growth (%)	-	*67.1*	*75.0*	-	*1,806.9*
Operating margin (%)	33.1	32.1	34.4	7.0	27.0
Net margin (%)	32.7	29.3	31.0	5.7	24.3

Source: Company

Development strategy. The company plans to expand the scale and scope of its products and services through research and development, international partnerships, increasing the share of high-end and high-margin products and focusing on services by leveraging on existing products. In drilling, it intends to focus on high-margin services by expanding its production capacity for drill collars and heavyweight drill pipes, increasing the volume of its drill-pipe leasing services, and expanding testing of drilling equipment. It also plans to provide borehole enlargement and drilling engineering services. In oil and gas production, it plans to expand its production capacity of high-end oilfield production equipment, develop and provide oilfield water treatment and EOR chemical services. In field services, it will develop new products and establish new bases in regions with promising long-term growth prospects. It also intends to establish a manufacturing center and a research and development center in Beijing's Huairou suburb by late 2008 .The company currently has 12 sales offices in China's major oil production areas and plans to establish on-site service bases throughout the country.

Potential beneficiary of consolidation. According to a Peking University Report, China has more than 1,200 non-government-owned oilfield services providers, which share about 10.0% of the country's oilfield service market. Based on FY12/06A revenue figures, the company had about 1.2% of the non-government-owned oilfield service market. To expand its market share and enhance portfolio, it plans to acquire other domestic non-government-owned companies with established track records and proven abilities. It is also considering acquiring international oilfield service companies to strengthen its technical capabilities.

Growth catalysts in China's oilfield service industry. With the dwindling oil and gas resources and complicated geological structure, China encourages private domestic and international oilfield service companies to participate in the sector. Growth catalysts include the development of newly discovered oil and gas fields, mature oilfield optimization, development of small and medium-size private upstream oil companies, development of small blocks and marginal oilfields and international demand for China's oilfield services.

Development of new oil and gas fields. Newly found oil and gas fields, including those in the Tarim Basin, Sichuan Basin, and Ordos Basin, are expected to replace mature oil and gas production bases in northern and eastern regions (Daqing and Shengli oilfields) as significant oil and gas production bases. The government is placing increased emphasis on the exploration and development of natural gas. In the new and emerging west and southwest regions, petroleum and natural gas deposits are found in deeper formations (5,000 meters or more), resulting in more hostile, high-pressure, high-temperature well conditions, which require specialized drilling and well completion services and equipment. Such formations frequently have corrosive sulphur-based gases, which significantly accelerate the corrosion process of down-hole drilling and production equipment.

Mature oilfield optimization. China's mature oilfields are concentrated in its eastern (Daqing, Liaohe, and Shengli) and northwest regions (Karamay oilfield). The output of these oilfields, whilst still important to China's overall oil production, will gradually decline, boosting demand for high-end oilfield services. Well completion is one example of value-added oilfield services, which play an important role in increasing the production recovery rates of mature oilfields. Compared with developed countries, the use of advanced well completion and other production enhancement techniques remains relatively low in China. Domestic companies are expected to focus on developing these technologies to capitalize on the rising demand.

Small and medium private upstream companies. Outside of the three major national oil companies (PetroChina, Sinopec and CNOOC), China's upstream market has become increasingly active due to government support for private upstream entrants. An increasing number of medium-size private upstream oil companies have emerged, generally focusing on smaller blocks and oilfields onshore China. Unlike the state-owned giants, private oil companies do not have their own oilfield service divisions and represent an emerging market for Chinese oilfield service companies.

Development of small blocks and marginal oilfields. China's upstream production has historically focused more on large oilfields, such as Daqing and Shengli. However, the government is currently encouraging the development of smaller blocks and marginal oilfields, as the current strong oil price has improved the viability of previously uneconomic fields. The development of smaller and marginal blocks is expected to drive demand for oilfield services particularly from private providers.

International demand for China oilfield services. We expect demand for China's low-cost oilfield services and equipment providers from other emerging markets to increase. Chinese manufacturers and drilling companies have already begun exporting their rig and drilling equipment, as well as drilling and well services to the Middle East, Africa, Latin America, and Central Asia. Chinese oilfield services companies have also followed Chinese exploration and production companies abroad.

Risk factors. 1) Tight working capital. The company's trade receivable turnover days increased substantially to 187 in FY12/06A from 105 in FY12/04A. It recorded a negative operating cash flow of RMB95.4m in FY12/06A and RMB35.5m in 1H FY12/07F. 2) Over-reliance on three major clients, CNPC, PetroChina and Sinopec, which accounted for about 67.9% of its revenue in FY12/04A, 75.7% in FY12/05A and 86.1% in FY12/06A. 3) Short operating history. 4) Shortage of technical experts and executives in China's oilfield services.

Valuation. The group is trading at P/E of 27.6x for FY12/07F, compared with one-year forward P/E of 17.5x and two-year forward P/E of 14.4x for the international oil and gas E&P peripheral sector. Meanwhile, Hong Kong-listed oil and gas E&P peripheral peers are trading at one-year forward P/E of 34.7x and two-year forward P/E of 25.4x. China Oilfield Services (2883 HK, HK$15.26, NR), a close comparable but with an offshore focus, is trading at a premium to the group's valuation, because of its proven track record, backup from CNOOC and developed operation platform.

Table 2: International E&P peripheral product/service providers

Company name	Ticker	Year end	Currency	Market cap (US$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
T-3 Energy Services	TTES US	Dec	USD	550.6	19.4	14.0
CARBO Ceramics	CRR US	Dec	USD	925.2	17.3	15.3
National Oilwell Varco	NOV US	Dec	USD	25,212.5	18.9	15.3
Gulf Island Fabrication	GIFI US	Dec	USD	423.4	14.4	11.4
Dril-Quip	DRQ US	Dec	USD	2,193.3	21.3	17.5
NATCO Group	NTG US	Dec	USD	940.3	21.4	17.8
FMC Technologies	FTI US	Dec	USD	7,239.5	25.1	20.1
Grant Prideco	GRP US	Dec	USD	6,847.6	13.0	11.9
Dresser-Rand Group	DRC US	Dec	USD	3,067.2	25.6	17.0
Complete Production Services	CPX US	Dec	USD	1,349.8	7.8	8.3
Vallourec	VK FP	Dec	EUR	6,927.0	10.0	10.1
Scomi Group	SGB MK	Dec	MYR	4,541.6	11.8	10.2
R H Energy	RHE SP	Dec	SGD	174.6	48.0	10.3
KS Energy Services	KST SP	Dec	SGD	1,101.8	9.6	8.6
Average					*17.5*	*14.4*

Source: Bloomberg

Table 3: HK-listed E&P peripheral product/service providers

Company name	Ticker	Year end	Currency	Market cap (US$m)	P/E (x) 1-yr forward	P/E (x) 2-yr forward
Shandong Molong Petroleum Machinery	568 HK	Dec	HKD	552.5	22.6	15.6
Anhui Tianda Oil Pipe	8241 HK	Dec	HKD	367.7	15.7	12.0
Jutal Offshore Oil Services	3303 HK	Dec	HKD	183.9	22.2	15.5
Emer International	8149 HK	Dec	HKD	272.3	*38.1*	*21.0*
China Oilfield Services	2883 HK	Dec	HKD	15,163.6	35.7	26.3
Average					*34.7*	*25.4*

Source: SBI E2-Capital