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Falcon Energy Group Limited

05 Aug 09

Initiate Report

Ready for the East Wind

Summary:

We like Falcon Energy Group's (Falcon) business model as its revenue model has an asymmetrical relationship to oil price - the company's revenue increases when oil price increases but stays stable when oil price falls. Furthermore, Falcon's long established experience (of about 20 years) in the business is a natural differentiation factor. To tip the scale against its competitors, Falcon provides a team of about 25-30 personal crew to its customers to enhance services.

We believe Falcon is now in a sweet spot. Demand for oil has not been abating and exploration and production activities will pick up as the emerging markets grow. Thanks to the oversupply of OSV (Offshore Service Vessels) currently in the market – caused by the speculative period between 2005 and 2008 – Falcon can now expand their fleet at a relatively low cost to fulfill growing orders that is expected from the increasing demand.

Hence, we initiated Falcon with a buy call, at a target price of S$1.01, representing an upside of 34%. We forecast a strong revenue growth (26%-30% for explicit period) given the needs of developing markets and the cost structure to rise slightly. We arrive at our target price using a WACC of 9.3% and terminal growth of 3%. Our bear case scenario spells a slight downside of 4.7% and bull scenario represents a generous 92.1% upside.

Increase Exposure

Target Price **S$1.01**
Prev Closing Price **S$0.755**

Main Activities

Falcon is an investment holding company which offers a spectrum of services from exploration and drilling phase to the post production stage. The business is divided into three segments: Marine, Oilfield Service and Oilfield Project.

Financial Highlights

(Y/E Mar)S$m	FY08-15 mths	FY09F	FY10F
Revenue	73.8	76.8	99.8
Gross Profit	41.6	42.5	55.0
Net Profit	36.1	32.8	40.7
EPS (US cts)	5.15	4.44	5.50

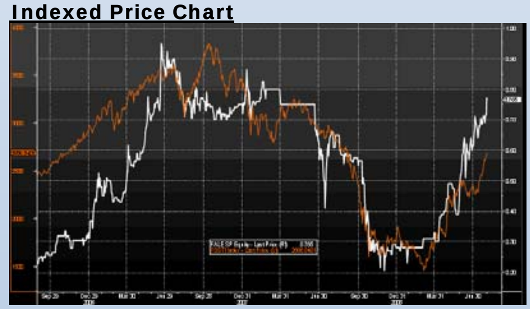
Source: Company, SIAS Research

Key ratios (FY09F)

PER	11.9
P/BV	3.7
ROA	15.9%
ROE	21.9%
Net Debt to Equity	Net Cash
Current ratio	2.36

Source: SIAS Research

Indexed Price Chart



Source: Bloomberg

52wks High-Low *S$0.795/S$0.205*
Number of Shares *739 m*
Market Capitalization *S$557.9m*

Analyst:

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Where Does the Falcon Hunt?: Trailing our analysis on the oil and gas industry (Oil Sector Outlook, Jul 9,2009), we remain bullish on the service subsector but shun counters that are looking to venture into the deepsea terrain (Understanding the Subterranean, Aug 4, 2009). We have therefore decided to investigate further into Falcon Energy Group (Falcon) which we have identified as a laggard in our O&G report.

The company, formerly known as Sembawang Music Holdings (SMC), underwent a reverse takeover in 2006 and was renamed Falcon Energy Group. It then acquired Oilfield Services Company Limited in 2007 to establish its operations and continued to expand in 2009 by acquiring Terasa-Star Shipping, CDS Oilfield Service and Longzhu Oilfield Services.

Falcon is an investment holding company which offers a spectrum of services from exploration and drilling phase to the post production stage. The business is divided into three segments:

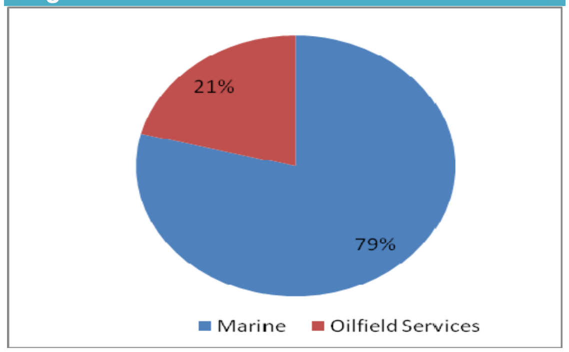
1. Marine,
2. Oilfield Service and
3. Oilfield Project.

The primary focus of the firm lies in the marine segment which includes offshore hook-up and commissioning, well intervention and subsea service and maintenance.

Oilfield Service and Oilfield Project are value added services implemented to provide a more comprehensive coverage for clients.

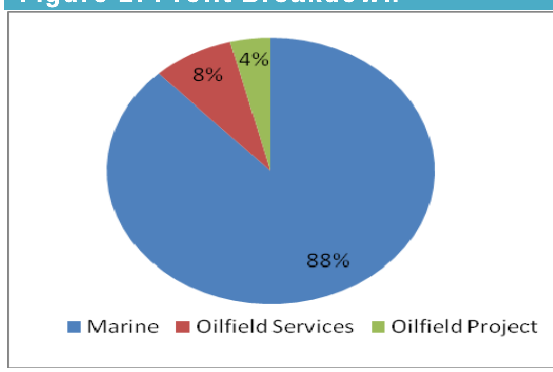
Currently, it owns 9 multi-purpose support vessels, 1 seismic survey vessel and 1 anchor handling tug supply (AHTS) vessel, with an average fleet age of 10-15 years old.

Figure 1: Revenue Breakdown



Source: Company, SIAS Research

Figure 2: Profit Breakdown



Source: Company, SIAS Research

Figure 3: Some of FEG's vessels

Source: Company

Figure 4: FEG's Fleet

Vessel	Descriptions
Support Station 1	Work Accommodation support Vessel (5180 Gross Tons)
Support Station 2	Work Accommodation support Vessel (5433 Gross Tons)
Support Station 3	Work Accommodation support Vessel (4568 Gross Tons)
Support Station 4	Work Accommodation support Vessel (4442 Gross Tons)
Support Station V	Work Accommodation support Vessel (5121 Gross Tons)
Falcon Warrior	Work Accommodation support Vessel (4988 Gross Tons)
Support Station 7	Work Accommodation support Vessel (1792 Gross Tons)
Energy Miner	Multi Purpose Work Vessel (2544 Gross Tons)
Atlantic Challenger	Anchor Handling Tug Supply Vessel (834 Gross Tons)
BGP Challenger	Seismic survey Vessel (2000 Gross Tons)
Energy Nexus	Supply Vessel (2000 Gross Tons)

Source: Company, SIAS Research

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Sea Water Speeds up Maintenance Needs of Oil Rigs: Oil rigs experience wear and tear as they operate to produce oil and the salty seawater increases the speed of such deterioration. There is therefore a consistent need to provide maintenance. This is where Falcon adds value.

Falcon's core specialty lies in providing an ideal work station where the chief engineer and his crew operate and reside. The vessel has a command post where the chief engineer can plan, execute and monitor the maintenance of oil rigs.

Some of the machinery are provided by Falcon to support the maintenance. Cranes are also attached to the barge to support certain lifting jobs. Most importantly, Falcon also deploys a personal crew of 25-30 people to the barge to provide service support to the customer's rig repair crew. This is more than the usual 3-4 people provided by Falcon's competitors.

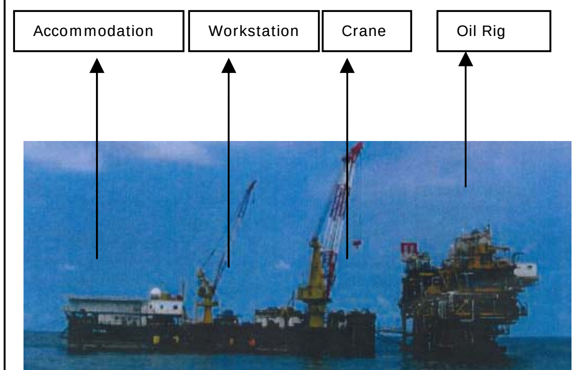
Differentiated by Experience and Strategy: Oil rigs are expensive equipment. Hence, the operators will look for a knowledgeable service provider that has the track record and skillful crew members.

Falcon is well-equipped with all the above factors and is a niche player with over 20 years of familiarity in the industry. Its personal crew of 25-30 people speeds up the services provided by the barge as they are more familiar with the equipment, such as the operation of the crane.

The cost of maintaining an oil rig is approximately US$2 million per day, due to the day rate of the rig, cost of other offshore support vessels and opportunity cost of zero oil production.

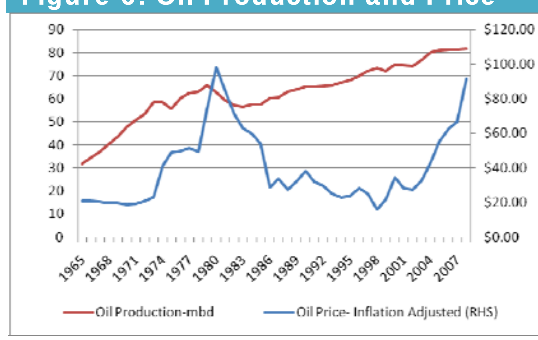
As a result, the rig owner will tend to hire an experienced support vessel with its crew which cost about US$30,000 daily. An efficient support operator can cut down the number of maintenance days, generating huge benefit to the owner.

Figure 5: Operation View



Source: Company, SIAS Research

Figure 6: Oil Production and Price



Source: BP Statistic, inflation data, SIAS Research

Low Sensitivity to Oil Prices: Production work in an oil rig is a continuous process. Regardless of price, the demand for oil remains substantial and this ensures a stable income for Falcon.

During economic downturns, O&G companies will tend to cut exploration and deepwater projects as these expenses are deemed more risky with higher breakeven cost. However, production cost generally remains constant.

The main operating region for Falcon lies in South East Asia where the production cost for oil lies about US$15 – US$25. Thus, even at the extreme scenario where the oil price falls back to US$30, there will still be business for Falcon.

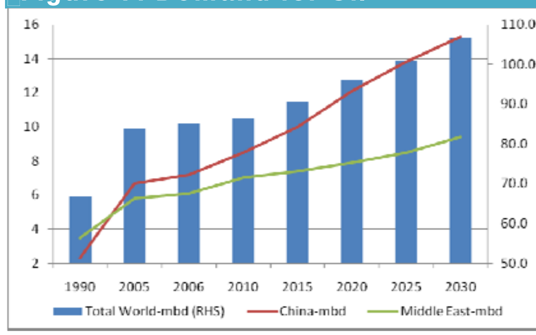
More, not Less, Demand for Oil: World demand for oil is estimated to rise from 85mbd (million barrels per day) in 2006 to 107mbd in 2030. Demand from non OECD (Organization for Economic Co-operation and Development) Asian countries is expected to double over this period. This will increase the number of offshore oil exploration and extraction projects over time. We believe that Falcon will be able to clinch more deals in the years to come.

Rig counts in Middle East and Asia Stable: The number of rigs contracted in the Middle East and Asia has been stable, at 100 compared to 103 a year ago for Asia and 83 compared to 99 a year ago. These rigs will require maintenance as they are put into production.

Rig utilization rate has been falling since mid 2008 due to weaker oil price, excess rig supply and fear of hurricanes in the Gulf of Mexico (Understanding the Subterranean, Aug 4, 2009). However, we believe that continuous increase in demand for oil will move utilization rate up over the next 12 months. We therefore remain bullish on the rig count usage in the region.

Offshore Service Vessels (OSV) Are Getting Cheaper: Between 2005 and 2008, many ship builders speculated in the OSV market. However, the financial crisis has severely affected the demand, resulting in an oversupply of OSVs in the market.

Figure 7: Demand for Oil



Source: IEA, SIAS Research

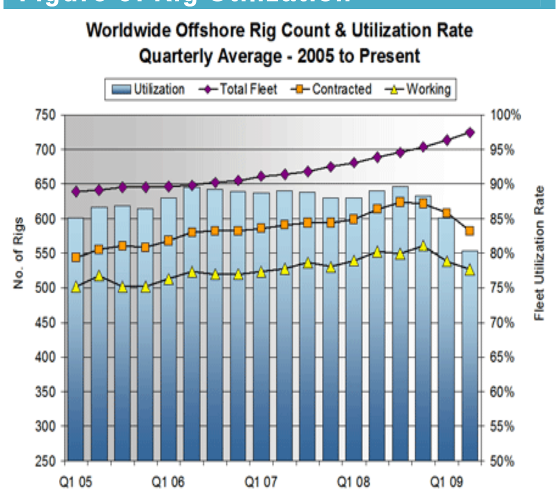
Figure 8: Rig Used in Asia and ME

Middle East	Today	Last Week	Month Ago	Year Ago
Total Rigs in Drilling Fleet	109	108	107	105
Rigs Under Contract	83	82	83	99
Rigs Without Contract	26	26	24	6
Fleet Utilization Rate	76.1%	75.9%	77.6%	94.3%

Asia/Australia (excludes India)	Today	Last Week	Month Ago	Year Ago
Total Rigs in Drilling Fleet	119	120	121	106
Rigs Under Contract	100	101	102	103
Rigs Without Contract	19	19	19	3
Fleet Utilization Rate	84.0%	84.2%	84.3%	97.2%

Source: ODS Petrodata

Figure 9: Rig Utilization



Source: ODS Petrodata

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ODS Petrodata's Jul 09 survey has reported that the oversupply of OSVs, coupled with falling demand, have affected the utilization rate in the industry.

As a result many of these barges are already "parked" in the shipyard to minimize operating cost.

The value of vessel is expected to fall further as the glut worsens. This however provides an opportunity for Falcon to expand its fleet at a lower cost.

Falcon Landed on a Sweet Spot. From the above, Falcon has landed onto a sweet spot – where it is going to enjoy the increase in demand for its services and yet be able to increase its capacity at low cost. Its growth potential over the next few years will be impressive.

Why Competitors Cannot Taste the Grape: Swiber is one of the closest comparables within the subsector. As of 1Q09, Swiber has 8 construction barges and 28 other offshore vessels, with 11 more ships joining the current team by end of the year.

But, its balance sheet is levered. Swiber sold and leased back 8 of its current vessels - most of which are new. Swiber however has a total debt to equity ratio of 1.38 - compared to Falcon's 0.17 with zero sale and leaseback agreement.

With a weaker balance sheet, Swiber may not be able to move as fast as Falcon.

Catch up if you Can: Even if Swiber can expand its fleet, it may not be able to catch up to Falcon's lucrative profit margin. Falcon's net profit margin is 47%, over 33% pts higher than the 14.6% provided by the industrial average and 11.2% provided by Swiber.

Falcon could maintain such a margin because of its ability to customize to the client's need, low financing and depreciation cost and most importantly, zero chartering expense.

Figure 10: Fleet Utilization

MAY 2009 DAY RATES, FLEET UTILIZATION

VESSEL TYPE	AVERAGE DAY RATES APR. '09	MAY '09	MAY '08	UTILIZATION MAY '09	MAY '08
AHTS					
Over 8,000 hp	$40,691	$40,691	$75,000	80%	99%
SUPPLY					
Under 200'	$ 5,667	$ 5,500	$ 7,125	75%	92%
200' and over	$14,688	$13,870	$18,425	88%	97%
CREWBOATS					
Under 125'	$ 3,500	$ 2,925	$ 3,650	78%	85%
125' and over	$ 5,917	$ 5,720	$ 7,180	88%	95%

SOURCE: *WorkBoat* survey of 32 offshore service vessel companies.

Source: WorkBoat

Figure 11: Peer Comparison

	Debt to Equity	Profit Margin
HAI LECK HLDS	0.1	11.0
CH OFFSHORE LTD	5.0	62.9
EOC LTD	233.3	29.8
BOUSTEAD SING	15.2	18.1
SWIBER HOLDINGS	138.0	11.3
ADVANCED HLDGS	0.0	9.1
R H ENERGY LTD	8.3	-18.8
EZRA HOLDINGS	52.8	31.4
YANTAI RAFFLES	72.2	3.0
TECHNICS OIL & GAS	0.3	4.2
HIAP SENG ENGINE	1.9	4.0
MTQ CORP LTD	8.1	0.2
EZION HOLDINGS	19.3	24.1
Average	78.3	26.6
FALCON ENERGY GR	16.8	47.4

Source: Bloomberg, SIAS Research

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Valuation: We believe that Falcon's position in the sweet spot will allow it to grow its fleet over the next 3 years and to double its revenue to US$161 million by 2012. We also believe that they will be able to take advantage of this position to hold their cost down and achieve a gross profit margin of between 54.5% and 55.3%.

Using an Economic Profit approach and applying a WACC of 9.3% with terminal growth of 3%, we arrive at a target price of S$1.01, representing an upside of 33.8% for Falcon.

We have also done a sensitivity analysis of terminal growth and WACC on Falcon. Under the extreme condition of 1% terminal growth and 10.3% WACC, we arrive at a price of S$ 0.76 which implies a slight premium of 0.7%.

Figure 12: Economic Profit Valuation

USD'000	2008-15 mths	2009F	2010F	2011F	2012F	2013F
Revenue growth	91.4%	30.0%	30.0%	28.0%	26.0%	3.0%
COGS (% of Revenue)	-43.7%	-44.7%	-44.9%	-45.0%	-45.5%	-46.0%
Admin Cost (% of Revenue)	-13.8%	-13.5%	-14.0%	-14.1%	-14.1%	-14.4%
EBIT	37,918	35,447	44,565	56,006	68,998	69,788
Tax on EBIT	(670)	(886)	(1,337)	(2,240)	(3,450)	(4,885)
Deferred Tax Liability	(62)	(84)	(126)	(210)	(321)	(449)
NOPLAT	37,186	34,477	43,102	53,556	65,227	64,454
Beg Book Value	109,767	189,141	223,942	286,237	366,072	462,002
WACC		0.0932	0.0932	0.0932	0.0932	0.0932
Capital Charge		17,628	20,871	26,677	34,118	43,059
Economic Profit		16,849	22,231	26,879	31,109	21,396
Terminal						348,694
Discount Rate		0.97	0.89	0.81	0.74	0.68
Present Value		16,356	19,740	21,833	23,115	14,542
Starting Book Value		189,141				
Explicit Value		95,586				
Terminal Value		236,999				
Value of Firm		521,726				
Number of Shares		739,000				
Value per Share		US$0.71				
US Dollar Conversion		1.43				
Value in S$		$1.01				

Serial

Source: SIAS Research Estimate

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Figure 13: Sensitivity Analysis

		WACC				
		8.30%	8.80%	9.30%	9.80%	10.30%
Terminal Growth	1%	$ 1.08	$ 0.98	$ 0.90	$ 0.83	$ 0.76
	2%	$ 1.16	$ 1.05	$ 0.95	$ 0.86	$ 0.79
	3%	$ 1.28	$ 1.13	$ 1.01	$ 0.91	$ 0.83
	4%	$ 1.44	$ 1.25	$ 1.10	$ 0.98	$ 0.87
	5%	$ 1.71	$ 1.44	$ 1.23	$ 1.07	$ 0.94

Source: SIAS Research Estimate

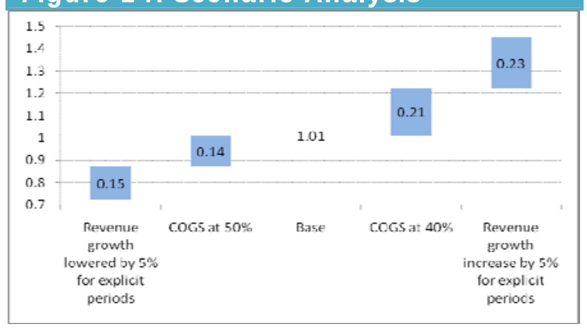
While we are hopeful of Falcon's performance going forward, there are risks to consider.

A scenario analysis shows that with a bear case of 50% COGS and 5% lower explicit revenue growth; we will arrive at a value of S$0.72. On the bullish side, a fair price of S$1.45 is estimated, with 40% COGS and 5% higher explicit revenue growth.

We also compare our valuation with Falcon's peer Price/Earnings ratio. After adjusting the 15 months of earning in 2008 for Falcon, the counter is still trading at a P/E of 13.14, below its peers' average of 14.09. If we par Falcon to its peers' average P/E, it should be trading at a price of S$ 0.81.

However, this price does not include the potential upside Falcon can attain by leveraging on its balance sheet and vessels.

Figure 14: Scenario Analysis



Source: SIAS Research Estimate

Figure 15: Peer Valuation

	P/E	Return on Equity
EZRA HOLDINGS	12.84	54.96
EZION HOLDINGS	57.21	6.92
SWIBER HOLDINGS	7.53	20.28
BOUSTEAD SING	6.47	33.48
CH OFFSHORE LTD	2.96	30.29
YANTAI RAFFLES	13.21	4.83
EOC LTD	5.9	25.54
HIAP SENG ENGINE	18.83	25.52
HAI LECK HLDS	1.51	74.58
TECHNICS OIL	17.48	16.43
MTQ CORP LTD	19.87	19.16
ADVANCED HLDGS	8.33	11.31
R H ENERGY LTD	11.04	15.22
Average	14.09	26.04
FALCON ENERGY GR	13.14	52.11

Source: Bloomberg, SIAS Research Estimate

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Figure 16: Financial Forecast and Estimate

Profit and Loss	2007	2008-15 mths	2009F	2010F	2011F	2012F	2013F
Revenue	38,582	73,838	76,792	99,829	127,781	161,004	165,834
Cost of Sales	(17,738)	(32,283)	(34,326)	(44,823)	(57,501)	(73,257)	(76,284)
Gross Profit	20,844	41,555	42,466	55,006	70,280	87,747	89,551
Other operating income	2,615	6,236	3,000	3,100	3,200	3,300	3,400
Administrative Cost	(4,344)	(10,163)	(10,367)	(13,976)	(18,017)	(22,702)	(23,880)
Finance Cost	(660)	(1,159)	(1,793)	(2,641)	(3,619)	(4,759)	(5,676)
Share of profit of associate	-	290	348	435	544	653	718
Profit before tax	18,455	36,759	33,654	41,924	52,387	64,239	64,112
Income tax	(253)	(650)	(841)	(1,258)	(2,095)	(3,212)	(4,488)
Profit from continuing operations	18,202	36,109	32,813	40,666	50,291	61,027	59,624
Loss from discontinued operation	(830)	-	-	-	-	-	-
Profit and Loss for Year	17,372	36,109	32,813	40,666	50,291	61,027	59,624

Cash flow	2007	2008-15 mths	2009F	2010F	2011F	2012F	2013F
Profit before income tax	17,625	36,759	33,654	41,924	52,387	64,239	64,112
Change in operating cashflow exclude working capital	3,854	5,883	8,447	9,714	12,367	15,903	17,552
Operating cash flows before movements in working capital	21,479	42,642	42,101	51,637	64,754	80,142	81,663
Change in working capital	(13,971)	10,247	(6,551)	(1,684)	(3,256)	(3,911)	(1,434)
Cash generated from operations	7,508	52,889	35,550	49,953	61,498	76,231	80,229
Income tax paid	(6)	(588)	(757)	(1,132)	(1,886)	(2,891)	(4,039)
Net cash from operating activities	7,502	52,301	34,793	48,821	59,613	73,341	76,190
Net cash used in investing activities	(34,213)	(52,707)	(15,767)	(45,413)	(54,676)	(65,617)	(19,665)
Net cash from financing activities	26,045	7,240	18,303	9,245	11,782	14,643	1,835
Net change in cash and cash equivalents	(666)	6,834	37,329	12,654	16,719	22,366	58,360
Effect of exchange rate changes	2	11	(20)	(25)	(30)	(33)	(35)
Cash and cash equivalents at beginning of year	3,182	2,518	9,363	46,672	59,301	75,990	98,323
Cash and cash equivalents at end of year	2,518	9,363	46,672	59,301	75,990	98,323	156,648

Balance Sheet	2007	2008-15 mths	2009F	2010F	2011F	2012F	2013F
Current Assets							
Cash and cash equivalents	2,518	10,271	45,764	60,301	75,990	97,323	156,648
Trade receivables	11,663	12,936	12,804	15,013	19,347	24,547	27,781
Other receivables	6,149	6,981	6,778	7,948	10,242	12,995	14,708
Inventories	2,715	1,188	2,033	2,384	3,187	4,043	4,576
Total	23,045	31,376	67,379	85,646	108,766	138,908	203,712
Non Current Assets							
Other receivables	4,800	1,526	3,239	3,886	5,007	6,353	7,190
Property, plant and equipment	67,833	119,857	128,392	166,066	210,980	264,386	270,945
Investment in associate	-	5,790	7,123	6,731	8,362	9,107	8,924
Current Liabilities							
Trade payables	4,586	5,901	5,395	6,371	8,288	10,722	12,412
Other payables	6,108	17,144	13,322	15,038	18,418	22,229	25,422
Finance leases	28	16	13	10	7	4	1
Borrowings	3,113	7,215	9,380	12,662	16,208	19,936	21,730
Income tax payable	254	316	400	526	735	1,057	1,505
Total	14,089	30,592	28,510	34,608	43,657	53,947	61,070
Non Current Liabilities							
Finance leases	46	43	31	24	17	10	3
Borrowings	9,019	21,129	27,468	37,081	48,947	63,632	69,359
Total	9,065	21,172	27,499	37,105	48,964	63,642	69,362
Share capital	8,132	179,524	190,224	190,224	190,224	190,224	190,224
Capital reserve	165,892	-	-	-	-	-	-
Merger reserve	(148,064)	(154,954)	(154,954)	(154,954)	(154,954)	(154,954)	(154,954)
Revaluation reserve	3,262	3,262	3,262	3,262	3,262	3,262	3,262
Foreign currency translation reserve	2	(456)	(630)	(804)	(1,218)	(1,573)	(2,022)
Accumulated Profits	43,300	79,409	112,222	152,888	203,179	264,206	323,830
Total Equity	72,524	106,785	150,124	190,615	240,493	301,166	360,340

Source: SIAS Research Estimate

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