

Velesto Energy Berhad (VEB MK)

A beneficiary of JU's upcycle

TP raised to MYR0.22. BUY.

We have raised FY23-24's earnings forecasts by 20%-35% largely to reflect the higher DCRs (+14%-21%) outlook over the next 24M. The JUs DCR is improving significantly. SEA's JUs utilisation has surpassed 90%, a tell-tale sign that market tightness is setting in. New contract tenures are lengthening, a positive as clients look to lock-in on charter availability. Velesto is in an entrenched position to ride this upcycle. Our revised TP is pegged to 0.9x EV/ replacement value (mean).

JUs market tightens, tenures lengthening

Demand for JUs is rising fast, with global/ SEA's marketed utilisation surpassing 90%/ 80%, a level not seen since 2014, fuelled by the strength of oil price (sustaining >USD70/bbl), energy security, higher capex and decreased supply over the past 7 years. The Middle East market is the main source of growth (+50%), the key driver of this upcycle. As the market tightens, the length of contracts is also increasing (from sub-12M to over 12M now), as operators are now fearful of not securing JUs.

DCRs inflecting

As such, DCRs benchmark range has trended upwards, to: (i) USD73k-120k (for JU specs of <350 IC; vs. USD73k-87k) and (ii) USD80k-109k (for JU specs of >350 IC; vs. USD75k-104k) now in SEA. The JUs DCR in SEA has not breached the USD100k mark since 2015. In MY, there is a significant increase in JU order book visibility, as PETRONAS ramps up its drilling works. Based on Velesto's recent rig schedule program for 2023, it could potentially reach >80% utilisation, should all the tenders currently under negotiation turn into contracts.

Raise FY23-24 earnings estimates, more upside

Our 20%-35% increase in earnings reflects higher DCRs of USD80k-85k (vs. USD70k previously). This is conservative, for it reflects the low range of SEA's DCRs. Based on our sensitivity analysis, every USD1k increase in DCR would raise its FY23's net profit by MYR6m. Apart from DCR, we also see scope for higher utilisation upgrade, which currently stands at 74%-80% for FY23-24. That said, JU opex has also increased by 10%-20% now, as a consequence of higher energy price.

FYE Dec (MYR m)	FY20A	FY21A	FY22E	FY23E	FY24E
Revenue	547	378	474	594	668
EBITDA	297	108	159	267	333
Core net profit	(18)	(181)	(28)	72	128
Core EPS (sen)	(0.2)	(2.2)	(0.3)	0.9	1.6
Core EPS growth (%)	nm	nm	nm	nm	77.7
Net DPS (sen)	0.0	0.0	0.0	0.0	0.0
Core P/E (x)	nm	nm	nm	9.7	5.5
P/BV (x)	0.5	0.4	0.3	0.3	0.3
Net dividend yield (%)	0.0	0.0	0.0	0.0	0.0
ROAE (%)	(19.4)	(4.0)	(1.3)	3.2	5.4
ROAA (%)	(0.5)	(5.6)	(1.0)	2.5	4.3
EV/EBITDA (x)	6.5	11.8	5.7	2.9	1.7
Net gearing (%) (incl perps)	34.9	12.8	9.2	3.3	net cash
Consensus net profit	-	-	(33)	21	57
MKE vs. Consensus (%)	-	-	15.2	250.3	125.5

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BUY

Share Price	MYR 0.09
12m Price Target	MYR 0.22 (+159%)
Previous Price Target	MYR 0.20

Company Description

Velesto is Malaysia's largest JU drilling rig operator by fleet size.

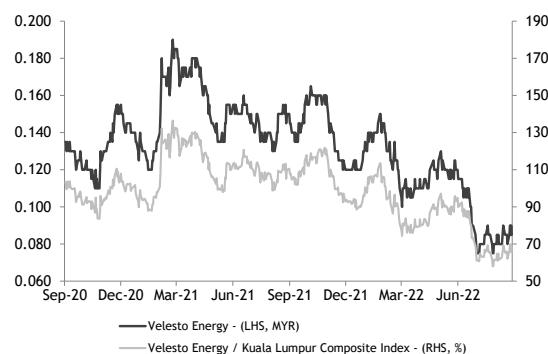
Statistics

52w high/low (MYR)	0.17/0.08
3m avg turnover (USDm)	0.2
Free float (%)	81.3
Issued shares (m)	8,216
Market capitalisation	MYR698.3M
	USD155M

Major shareholders:

Permodalan Nasional Bhd.	47.2%
Bumiputra Investment Foundation	14.1%
Lembaga Tabung Haji	5.0%

Price Performance



	-1M	-3M	-12M
Absolute (%)	13	(32)	(43)
Relative to index (%)	13	(31)	(40)

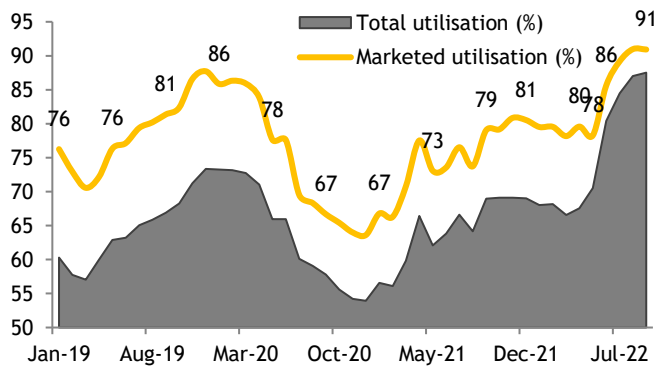
Source: FactSet

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Tear Sheet Insert

Value Proposition

- Malaysia’s JU rigs operator with a relatively young fleet (6 units, averaging 9 years).
- JUs are Malaysia-flagged and owned and will be able to capitalise on Malaysian cabotage rules.
- Velesto is going through a challenging but gradually improving macro environment, as it faces a bottoming of DCRs but gradual recovery of JU utilisation.
- Returns outlook is improving but the pace of recovery will be gradual, backed by its continuous efforts to optimise costs and utilisation.

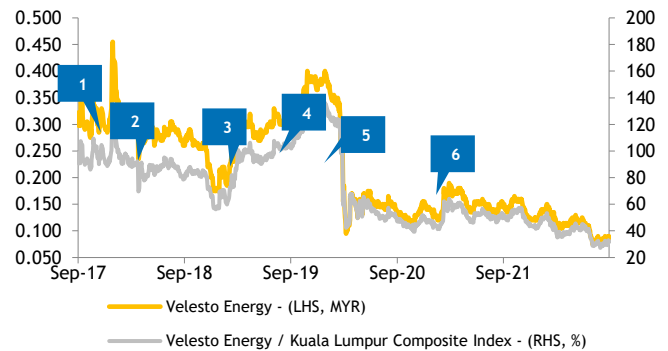
SEA JUs utilisation (%) 2019 onwards



Source: Various

Price Drivers

Historical share price trend



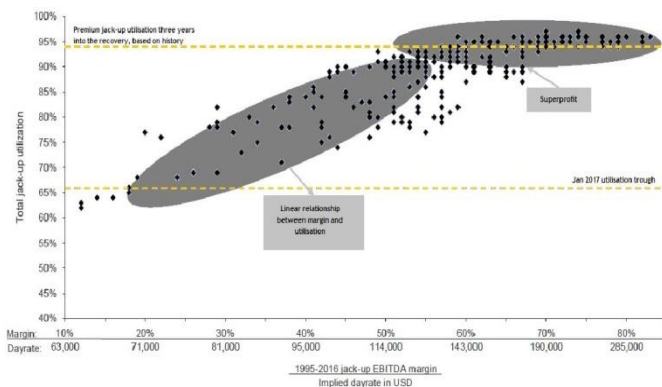
Source: Company, Maybank IBG Research

1. Proposed merger of UMWOG-Icon Offshore-Orkim in Jan 2018.
2. UMWOG-Icon Offshore-Orkim merger falls through. (UMWOG changed name to Velesto on 21 May 2018).
3. Secured 4 charters from PCSB (1+1+1 year contract) with improved DCRs.
4. Won Carigali Hess 3-year job with a USD99k DCR.
5. OPEC+ pact falls apart in Mar 2020.
6. Lost Naga 7 rig during ops in May 2021.

Financial Metrics

- JU DCR, utilisation and opex are Velesto’s key earnings drivers. Variations to any of these parameters will impact profitability.
- Softness in utilisation and earnings expected due to seasonality effect but cash flow remains positive, on better cost control.
- With low oil prices, cost management, capital discipline and cashflow preservation are priorities over growth.

Historical JU margin & utilisation



Source: Company

Swing Factors

Upside

- Recovery in crude oil prices a near-term stock driver.
- Rising utilisation/DCRs and margin expansion are key catalysts.
- Though unlikely in our view, a potential privatisation exercise would likely generate excitement.

Downside

- Further weakness in oil price will hurt share price performance.
- Execution mishap, cost overruns and / or absence/ non-extension of charters will cause adverse reaction.
- Failure to meet debt repayment/covenant is a sign of financial distress.

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Risk Rating & Score ¹	Medium & 21.2
Score Momentum ²	-14.6
Last Updated	31 Mar 2022
Controversy Score ³ (Updated: 5 May 2017)	0

Business Model & Industry Issues

- Continues to improve on its sustainability journey & milestones: (i) started its Sustainability reporting in 2017, (ii) improved disclosures in 2018 (with a more systematic data-gathering approach), (iii) adoption of 6 UNSDGs in 2019, (iv) developed its Sustainability Blueprint in 2020 and (iv) set emissions intensity reduction goal in 2022: 10% by ope. days & 30% by revenue.
- As a service provider in the O&G industry (drilling ops), Velesto’s operations have limited direct exposure to the risk of environmental damage but improved ‘E’ targets (i.e. carbon emissions, carbon neutral, net zero) would be well-received.
- We are comfortable with Velesto given its strong track record across the ESG parameters and compliance with international standards.

Material E issues

- It consumed: (i) 19,522 MT of diesel, (ii) 468,247 kWh of electricity, (iii) 841 (-11% YoY) TJ of energy and (iv) 13,184 MT per rig (-4%) of water (used for drilling rig ops, mainly seawater and 60%-70% of water withdrawn is used for non-potable applications such as flushing & drilling) in FY20.
- Its: (i) GHG emissions (Scope 1 & 2), (ii) chemical waste and (iii) scheduled solid & chemical waste in FY20 totalled 62,860 TCO²e (FY19: 70,288 TCO²e), 239 MT (+2%) and 280 MT -8% respectively.
- Reported zero major spills (for the 4th consecutive year) from is JUs in 2020.
- As a common practice, all its JUs continue to operate in marine locations deemed NOT high in biodiversity/ considered sensitive to ecological challenges.
- Participates in Plug and Abandonment decommissioning activities and complies with the local/ international conventions.

Material S issues

- Has a diversified workforce, with over 15 nationalities with relatively low attrition rates (17%) vs. industry.
- 16%-23% of its workforce is below 30 years old in FY18-20.
- 42%/ 39%/ 16% of its senior & management/ onshore/ overall workforce respectively is female represented. Does not intend to set any target for gender diversity. Adopts equal opportunity employment.
- Registered zero: (i) Loss Time Incident (LTI), (ii) recordable case (TRC) incidents and (iii) environmental related incidences in 2020.
- Its Hazard Observation Card (HOC) score was 230,179 in 2020. Unsafe Act and Unsafe Condition (UAUC) card accounted for was 21.3% of HOC. Data verified by DNV-GL.
- An unfortunate incident involving Naga 7 caused it to be fully submerged on 3 May 2021. All 101 personnel were safely evacuated to shore. Recognised USD130m in insurance claims & made a net gain of MYR90m on this.

Key G metrics and issues

- A constituent of the FTSE4Good Index Series and a winner of the ASEAN Corporate Governance Scorecard awards (under the ASEAN Asset Class Award category).
- Velesto’s board comprises 8 directors - 3 Independent Non-Executive Directors (INEDs), 1 Senior INED (SINED), 3 NINEDs (incl. Chairman), and 1 NIED (President).
- A very experienced and gender-diversified board with good mix of tenure of service - 67% are above 60 years old, 47% are female and 45% have served 6-9 years.
- PNB, a major shareholder of Velesto (54%) has 1 board seat representation (direct appointment).
- The President’s total remuneration package of MYR1.8m for FY20 accounted for 0.6% of the Group’s EBITDA.
- Velesto is audited by Ernst & Young PLT (EY), one of the Big Four accounting firms in the world.
- Its Audit Committee is made up of 3 INEDs and 1 SINED.
- Its Board Risk Management Committee is made up of 1 SINED, 2 INEDs and 1 NINED.
- Its Board Nomination & Remuneration Committee comprise of 3 INEDs and 1 NINED.
- Its recurring related party transactions (RPTs), which mainly comprised interest income and management fees & rental, made up 11% of its revenue in FY20.
- The de-merger of UMW Holdings and Velesto (formerly known as UMW O&G) in 2016 was completed in 2017.
- Subsequently, the planned merger with Icon Offshore and Orkim S/B in Jan 2017 was aborted in May 2017 following a due diligence exercise.
- Proposed a 14-for-5 rights issue @ MYR0.30/ unit in Oct 2017, raising MYR1.8b to recapitalise its balance sheet.
- Shareholders approved the Proposed Share Capital reduction (i.e. reduction & cancellation of MYR2.2b of issued share capital); completed on 21 Oct 2020.
- Undertook voluntary pre-payments totalling MYR585m since 2018 (FY20: MYR126m) to pare down debts.
- Substantial impairment exercises: MYR781m (2016), MYR982m (MYR2017) & MYR462m (2020).

¹**Risk Rating & Score** - derived by Sustainalytics and assesses the company’s exposure to unmanaged ESG risks. Scores range between 0 - 50 in order of increasing severity with low/high scores & ratings representing negligible/significant risk to the company’s enterprise value, respectively, from ESG-driven financial impacts. ²**Score Momentum** - indicates changes to the company’s score since the last update - a **negative** integer indicates a company’s improving risk score; a **positive** integer indicates a deterioration. ³**Controversy Score** - reported periodically by Sustainalytics in the event of material ESG-related incident(s), with the impact severity scores of these events ranging from Category 0-5 (0 - no reports; 1 - negligible risks; ...; 5 - poses serious risks & indicative of potential structural deficiencies at the company).

Recent JU market activities

- Aug 2022: PCSB's blend-and-extend of Borr's Idun JU contract hit above USD120k in 3Q22. PCSB exercised the option and extended the unit until Sep 2023.
- Jul 2022: Mubadala chartered Borr's Mist JU in for 210 days, with works commencing in early 2023 @ DCR of USD120k in Thailand.
- Brunei Shell Petroleum chartered Valaris' 115 JUs for 4 years (plus options), @ DCR of sub-USD110k.
- Icon agreed to sell its JU (built in 2014) to ADES Arabia Holding for USD85m, with the deal to be completed by 4Q22. Icon's exit from the JU business will see Velesto emerging as the sole local operator in MY.

Financials

The subpar FY22 earnings outlook is well-flagged. Based on Velesto's latest works schedule, we expect a stronger 2H22 (average: 75%) vs. 1H22 (40%). That said, the stronger Jul-Dec outlook is insufficient to return Velesto to the black in FY22. To break-even, Velesto in our view needs to hit a 69% utilisation level (vs. 61% our estimate).

Focus should be on FY23. We expect Velesto to turn around financially in FY23, as it leverages on PETRONAS' accelerated capex program for its drilling activities. While our forecast imputes a 74%-80% utilisation level for FY23-24, we do not rule out Velesto hitting a higher 81% in FY23, should all its tenders turn into contracts.

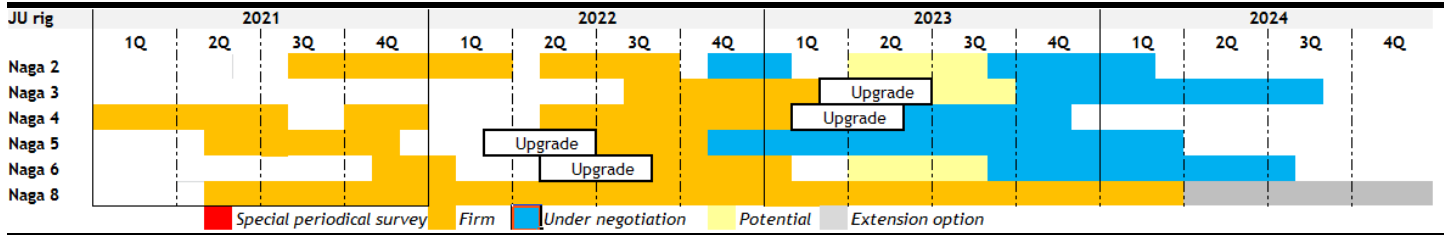
JUs upgrades. Meanwhile, 2 of its JUs (Naga 3 & 4) will undergo upgrade works (for offline capabilities) in FY23 (similar to Naga 5 & 6 in FY22).

Revisions

	Before	After	% chg
DCR (USD)			
- FY22	70,000	75,000	7.1
- FY23	70,000	80,000	14.3
- FY24	70,000	85,000	21.4
OPEX (USD)			
- FY22	30,000	34,200	14.0
- FY23	30,000	36,000	20.0
- FY24	30,000	36,000	20.0
Core NP (MYR'm)			
- FY22	(28.2)	(28.2)	-
- FY23	53.4	71.8	34.5
- FY24	106.8	127.6	19.5

Source: Company, Maybank IBG Research

JUs charters @ Aug 2022



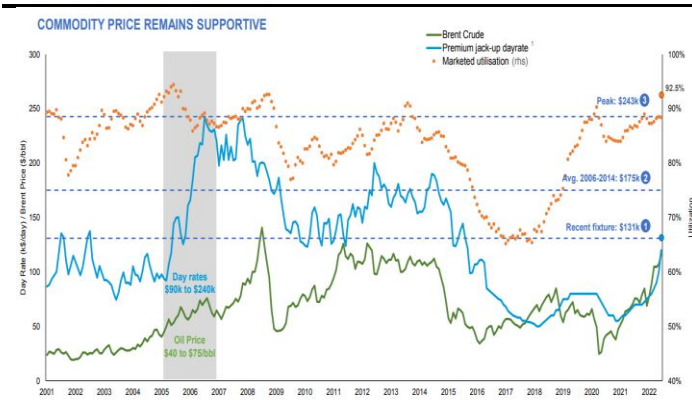
Source: Company, Maybank IBG Research

DCRs & utilization level

	FY17	FY18	FY19	FY20	FY21	FY22F	FY23F	FY24F
DCR (USD)	68,000	68,000	70,900	70,000	70,000	75,000	80,000	85,000
Utilization level (%)	20.8	71.2	80.2	65.8	47.6	60.7	74.0	79.5

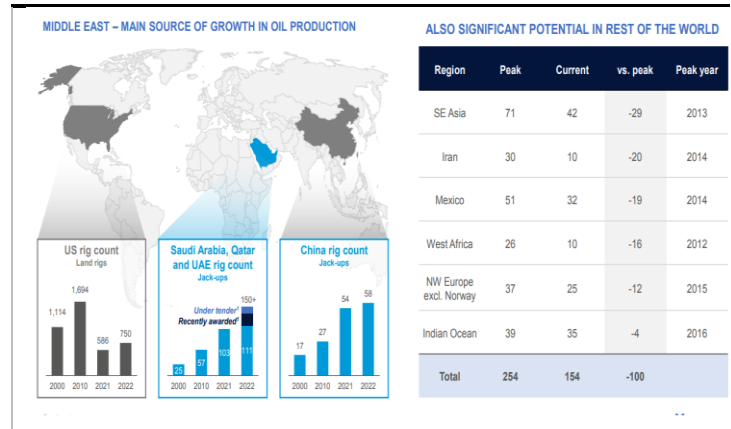
Source: Company, Maybank IBG Research

JUs DCRs - global



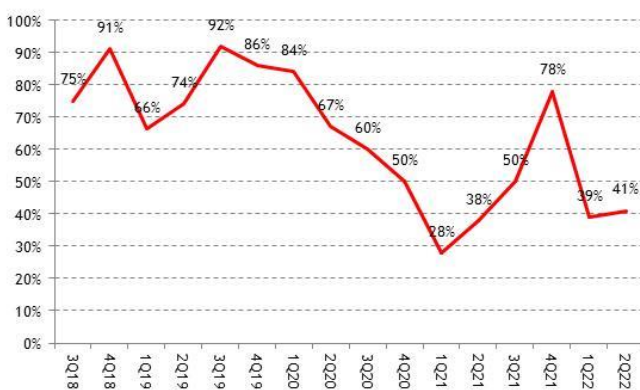
Source: IHS Petrodata, DNB Markets, Clarksons Platou, Borr Drilling

Shallow water drilling is a growth market



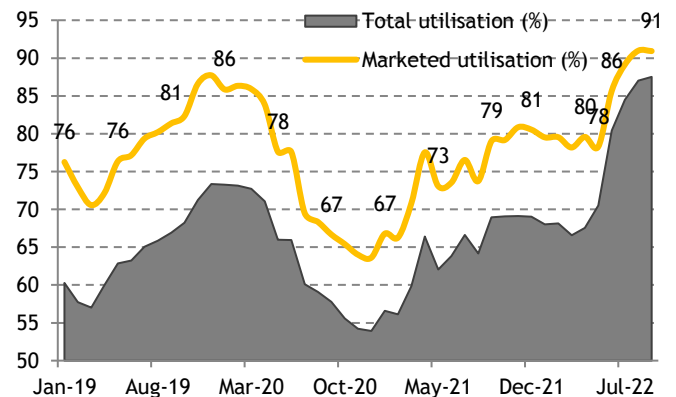
Source: IHS Petrodata, Clarksons Platou, RigLogix, Baker Hughes, Borr Drilling

Quarterly JU utilization



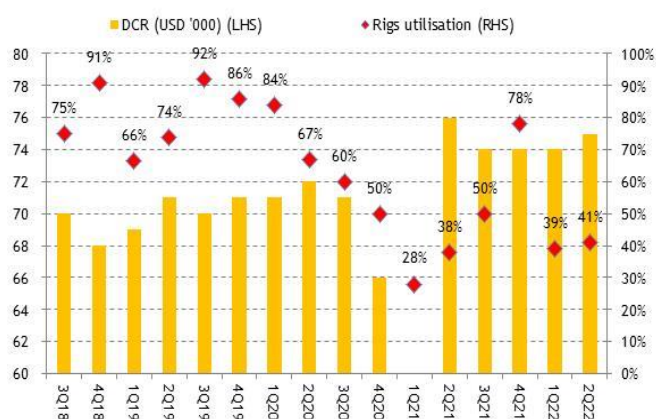
Source: Company, Maybank IBG Research

SEA JUs utilisation (%) 2019 onwards



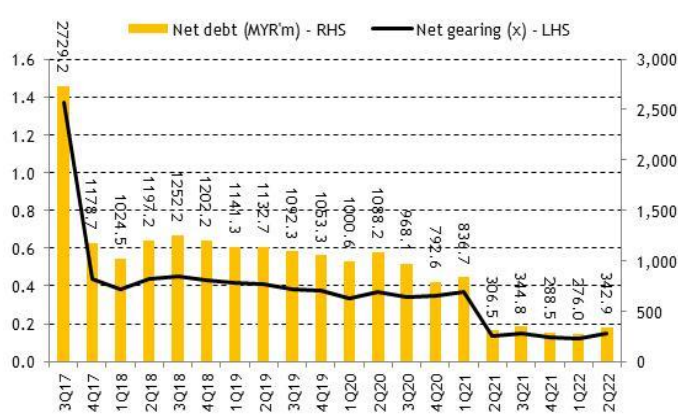
Source: Company, Maybank IBG Research

Quarterly JU utilization & DCR trend



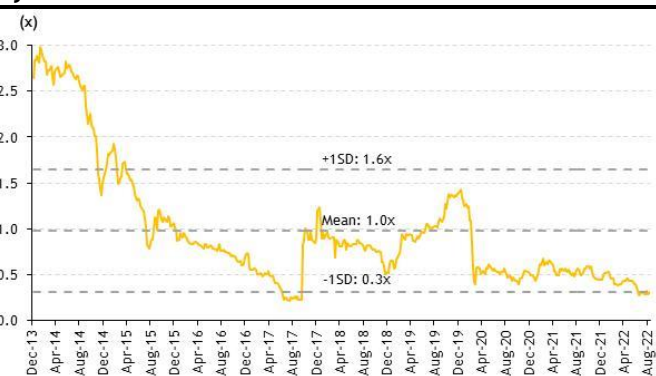
Source: Company, Maybank IGB Research

Quarterly net debt & gearing level



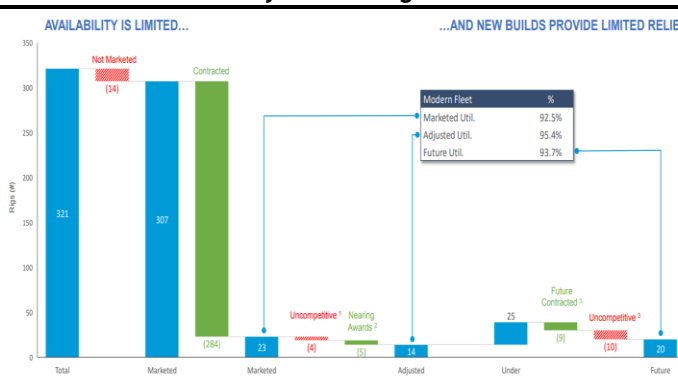
Source: Company, Maybank IGB Research

1-year forward PBV



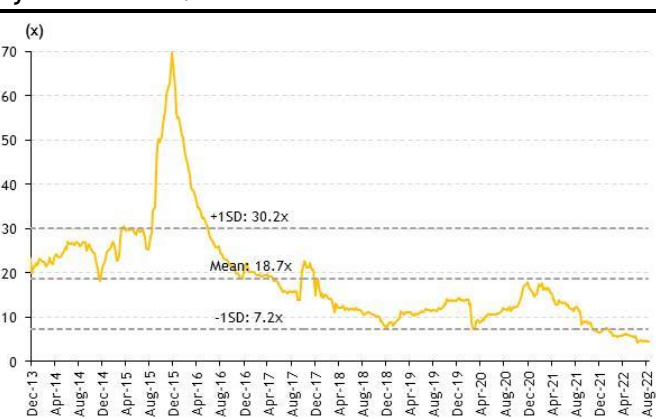
Source: Company, Maybank IGB Research

Modern fleet availability is shrinking fast



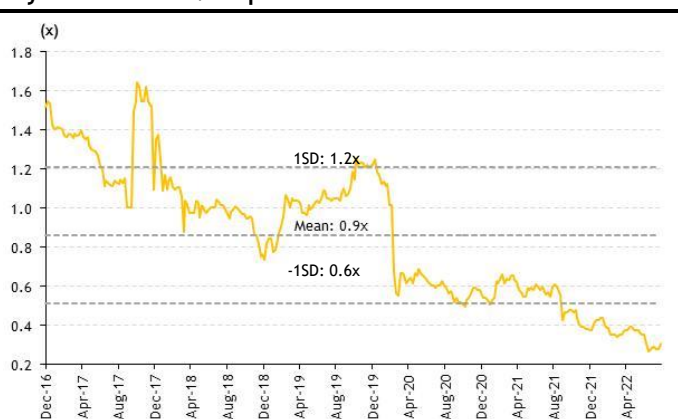
Source: Petrodata, S&P Global, Borr Drilling

1-year forward EV/ EBITDA



Source: Company, Maybank IGB Research

1-year forward EV/ replacement value



Source: Company, Maybank IGB Research

FYE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Key Metrics					
P/E (reported) (x)	nm	nm	nm	9.7	5.5
Core P/E (x)	nm	nm	nm	9.7	5.5
P/BV (x)	0.5	0.4	0.3	0.3	0.3
P/NTA (x)	0.5	0.4	0.3	0.3	0.3
Net dividend yield (%)	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	19.8	nm	11.8	18.7	30.9
EV/EBITDA (x)	6.5	11.8	5.7	2.9	1.7
EV/EBIT (x)	35.8	nm	nm	7.0	3.2

INCOME STATEMENT (MYR m)

Revenue	546.9	377.5	473.9	594.2	668.4
EBITDA	297.0	108.3	159.2	267.4	333.1
Depreciation	(242.7)	(243.7)	(152.4)	(156.4)	(160.4)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	54.3	(135.4)	6.8	111.0	172.7
Net interest income / (exp)	(58.2)	(37.4)	(36.7)	(23.9)	(21.0)
Associates & JV	0.2	0.2	0.0	0.0	0.0
Exceptionals	(473.3)	90.5	0.0	0.0	0.0
Other pretax income	0.0	0.0	(2.8)	(4.0)	(4.0)
Pretax profit	(477.0)	(82.2)	(32.7)	83.1	147.7
Income tax	(14.8)	(8.6)	4.4	(11.3)	(20.1)
Minorities	0.0	0.0	0.0	0.0	0.0
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	(491.7)	(90.8)	(28.2)	71.8	127.6
Core net profit	(18.5)	(181.3)	(28.2)	71.8	127.6

BALANCE SHEET (MYR m)

Cash & Short Term Investments	261.2	293.5	326.2	406.5	572.7
Accounts receivable	147.1	177.6	127.4	159.7	179.7
Inventory	199.6	173.5	217.8	273.1	307.2
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	2,720.7	2,293.1	2,170.7	2,044.3	1,913.9
Intangible assets	0.0	0.0	0.0	0.0	0.0
Investment in Associates & JVs	1.9	1.1	1.1	1.1	1.1
Other assets	123.7	65.8	64.8	64.8	64.8
Total assets	3,454.2	3,004.5	2,908.0	2,949.5	3,039.2
ST interest bearing debt	182.7	279.9	279.9	279.9	279.9
Accounts payable	89.5	94.9	77.6	97.3	109.4
Insurance contract liabilities	0.0	0.0	0.0	0.0	0.0
LT interest bearing debt	871.1	302.1	252.1	202.1	152.1
Other liabilities	40.0	69.0	68.0	68.0	68.0
Total Liabilities	1,183.4	746.4	678.1	647.8	609.9
Shareholders Equity	2,269.6	2,258.1	2,229.9	2,301.7	2,429.3
Minority Interest	1.2	0.0	0.0	0.0	0.0
Total shareholder equity	2,270.8	2,258.1	2,229.9	2,301.7	2,429.3
Total liabilities and equity	3,454.2	3,004.5	2,908.0	2,949.5	3,039.2

CASH FLOW (MYR m)

Pretax profit	(477.0)	(82.2)	(32.7)	83.1	147.7
Depreciation & amortisation	242.7	243.7	152.4	156.4	160.4
Adj net interest (income)/exp	0.0	0.0	0.0	0.0	0.0
Change in working capital	73.4	(33.4)	(11.5)	(67.9)	(41.9)
Cash taxes paid	(14.8)	(8.6)	4.4	(11.3)	(20.1)
Other operating cash flow	461.6	(148.2)	0.0	0.0	0.0
Cash flow from operations	285.9	(28.7)	112.7	160.3	246.1
Capex	(58.6)	(82.1)	(30.0)	(30.0)	(30.0)
Free cash flow	227.3	(110.7)	82.7	130.3	216.1
Dividends paid	0.0	0.0	0.0	0.0	0.0
Equity raised / (purchased)	0.0	0.0	0.0	0.0	0.0
Change in Debt	(239.5)	(471.8)	(50.0)	(50.0)	(50.0)
Other invest/financing cash flow	33.6	615.0	0.0	0.0	0.0
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	21.5	32.4	32.7	80.3	166.1

FYE 31 Dec	FY20A	FY21A	FY22E	FY23E	FY24E
Key Ratios					
Growth ratios (%)					
Revenue growth	(18.5)	(31.0)	25.5	25.4	12.5
EBITDA growth	(8.2)	(63.5)	47.1	67.9	24.6
EBIT growth	(56.6)	nm	nm	1,525.7	55.6
Pretax growth	nm	nm	nm	nm	77.7
Reported net profit growth	nm	nm	nm	nm	77.7
Core net profit growth	nm	nm	nm	nm	77.7
Profitability ratios (%)					
EBITDA margin	54.3	28.7	33.6	45.0	49.8
EBIT margin	9.9	nm	1.4	18.7	25.8
Pretax profit margin	nm	nm	nm	14.0	22.1
Payout ratio	0.0	0.0	0.0	0.0	0.0
DuPont analysis					
Net profit margin (%)	nm	nm	nm	12.1	19.1
Revenue/Assets (x)	0.2	0.1	0.2	0.2	0.2
Assets/Equity (x)	1.5	1.3	1.3	1.3	1.3
ROAE (%)	(19.4)	(4.0)	(1.3)	3.2	5.4
ROAA (%)	(0.5)	(5.6)	(1.0)	2.5	4.3
Liquidity & Efficiency					
Cash conversion cycle	200.4	210.9	200.2	204.7	227.1
Days receivable outstanding	138.1	154.8	115.8	87.0	91.4
Days inventory outstanding	134.8	110.9	150.8	182.9	210.7
Days payables outstanding	72.5	54.8	66.5	65.1	75.0
Dividend cover (x)	nm	nm	nm	nm	nm
Current ratio (x)	2.4	1.6	1.7	2.0	2.5
Leverage & Expense Analysis					
Asset/Liability (x)	2.9	4.0	4.3	4.6	5.0
Net gearing (%) (incl perps)	34.9	12.8	9.2	3.3	net cash
Net gearing (%) (excl. perps)	34.9	12.8	9.2	3.3	net cash
Net interest cover (x)	0.9	na	0.2	4.7	8.2
Debt/EBITDA (x)	3.5	5.4	3.3	1.8	1.3
Capex/revenue (%)	10.7	21.7	6.3	5.0	4.5
Net debt/ (net cash)	792.6	288.5	205.8	75.5	(140.6)

Source: Company; Maybank IBG Research

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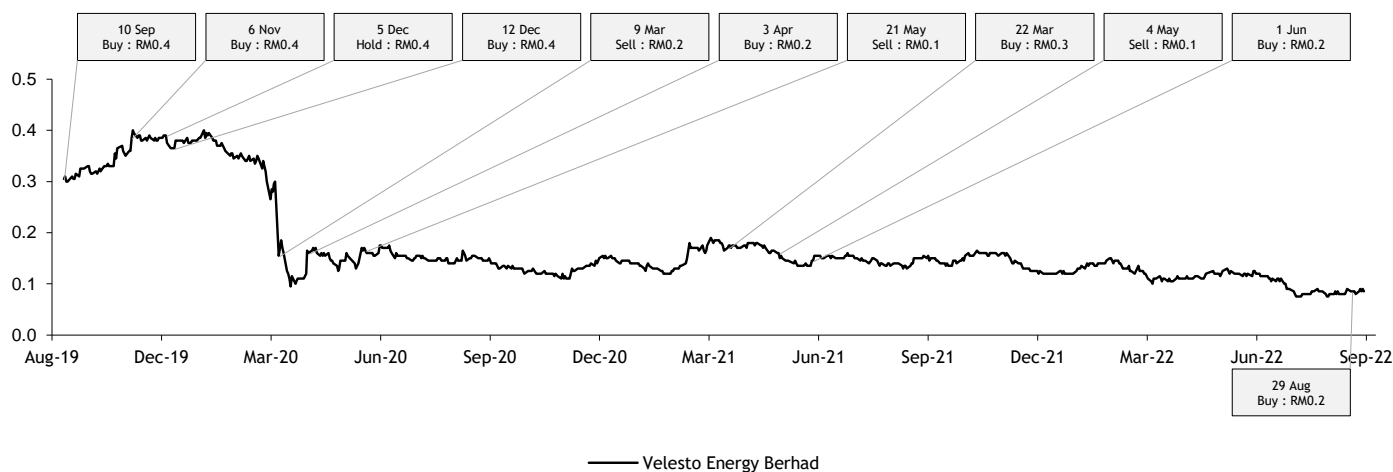
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