

## SPT Energy Group (1251 HK)

## Hold

Target price (HKD)	1.10
Share price (HKD)	1.28
Upside/Downside (%)	-14.1

Dec	2014 a	2015 e	2016 e
HSBC EPS	0.08	0.03	0.06
HSBC PE	12.9	30.2	17.2
Performance	1M	3M	12M
Absolute (%)	-22.0	-14.1	-68.3
Relative <sup>A</sup> (%)	-21.1	-18.1	-71.8

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Disclosures

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Hold: Difficult road ahead as core markets contract

- ▶ **2014 net profit declined 61% yoy to RMB116m, missing our estimates and consensus by 18%/13%**
- ▶ **Negatives: Lower capital spending, Kazakh Tenge (KZT) devaluation, and higher costs/taxes with a difficult outlook**
- ▶ **We establish a Hold rating (vs. Neutral (V) under our old rating system); we set a fair value TP of HKD1.10**

SPT reported 2014 net income of RMB116.2m, down 61% y-o-y, and 18%/13% below HSBCe and consensus estimates. The y-o-y decline was due mainly to: 1) oil majors cutting E&P capex as oil prices fell; 2) the KZT devaluation in February 2014 produced a one-off RMB60m loss; and 3) expansion-related cost escalation and an increase in the effective tax rate from c20% to c28%. The company will pay no dividend, whereas it paid out 25% in 2012-2013.

**Management guidance for 2015: negative growth in revenue likely and key target is to maintain positive profit.** 2014 revenue declined 9% as the contribution from drilling and well completion segments both fell at double-digits. SPT believes the trend is likely to continue into 2015. **Segment EBITDA margins fell across the board** - as drilling/well-completion/reservoir margins dropped 7%/6.7%/4.5% to 18.9%/18.9%/26.1%, respectively. Margins were impacted by revenue declines, and cost escalation in raw material and staffing. SPT expects margins to remain stable in 2015 as they will turn away from low-margin contracts.

**KZT depreciation remains an overhang.** However, SPT does not factor in another round of devaluation in 2015. The 23% devaluation of Turkmenistani Manat in Jan 2015 did not have impact as the Turkmen contracts are USD-denominated.

**Cut 2015-17e earnings.** Lower revenue growth and lower margin assumptions produce a lower net profit and we cut earnings estimates by 77%/61%/59% for 2015-17e.

**We establish new rating: hold SPT with new target price of HKD1.10.** To derive our TP, we apply a 0.75x PB to our 2015e BVPS estimates of HKD1.46/sh. Our 2015-17e earnings forecasts are 47-67%% below consensus, while our TP is 38% below. The stock is trading at a trough valuation level (0.9x P/B vs. historical avg. of 2.1x), which may prevent the share price from dropping much further below our TP. **Key upside risks:** 1) contract wins; 2) a deeper partnership with Halliburton, (e.g. direct equity investment); 3) investment in China conventional and shale gas, and 4) short covering. **Key downside risks:** 1) further weakness of KZT; 2) in-sourcing Chinese oil majors.

Index <sup>A</sup>	HANG SENG INDEX
Index level	24,495
RIC	1251.HK
Bloomberg	1251 HK

Source: HSBC

Enterprise value (CNYm)	1,424
Free float (%)	41
Market cap (USDm)	253
Market cap (HKDm)	1,964

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	2,187	2,001	2,198	2,333
EBITDA	287	261	292	308
Depreciation & amortisation	-83	-154	-130	-130
Operating profit/EBIT	204	107	162	177
Net interest	-44	-48	-47	-47
PBT	160	58	115	130
HSBC PBT	160	58	115	130
Taxation	-46	-15	-29	-32
Net profit	116	43	84	95
HSBC net profit	116	43	84	95

### Cash flow summary (CNYm)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Cash flow from operations	-91	336	132	182
Capex	-173	-200	-132	-117
Cash flow from investment	-206	-200	-132	-117
Dividends	-77	-11	-11	-21
Change in net debt	246	-136	11	-44
FCF equity	-67	136	0	66

### Balance sheet summary (CNYm)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Intangible fixed assets	65	65	65	65
Tangible fixed assets	767	813	815	801
Current assets	2,751	2,676	2,826	2,969
Cash & others	595	731	720	764
Total assets	3,583	3,555	3,707	3,835
Operating liabilities	1,203	1,131	1,207	1,260
Gross debt	432	432	432	432
Net debt	-163	-299	-288	-332
Shareholders funds	1,774	1,817	1,890	1,964
Invested capital	1,785	1,693	1,779	1,811

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	-9.0	-8.5	9.8	6.2
EBITDA	-40.8	-9.1	12.1	5.2
Operating profit	-50.7	-47.6	51.9	9.2
PBT	-58.8	-63.6	97.2	12.8
HSBC EPS	-58.9	-57.3	75.8	11.2

### Ratios (%)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Revenue/IC (x)	1.4	1.2	1.3	1.3
ROIC	9.0	4.6	7.0	7.4
ROE	6.5	2.4	4.5	4.9
ROA	4.4	2.4	3.5	3.7
EBITDA margin	13.1	13.0	13.3	13.2
Operating profit margin	9.3	5.3	7.4	7.6
EBITDA/net interest (x)	6.5	5.4	6.2	6.5
Net debt/equity	-8.5	-15.2	-14.1	-15.7
Net debt/EBITDA (x)	-0.6	-1.1	-1.0	-1.1
CF from operations/net debt				

### Per share data (CNY)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EPS reported (fully diluted)	0.08	0.03	0.06	0.07
HSBC EPS (fully diluted)	0.08	0.03	0.06	0.07
DPS	0.00	0.01	0.01	0.02
Book value	1.16	1.19	1.24	1.28

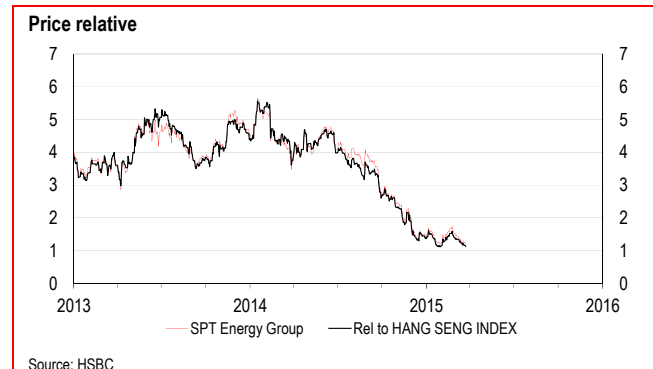
### Key forecast drivers

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Rev growth-drilling(%)	-14.31	-18.00	7.00	2.00
Rev growth-well completion(%)	-12.92	-14.00	10.00	5.00
Rev growth-reservoir(%)	0.58	5.00	12.00	10.00
EBITDA margin-drilling(%)	18.91	18.21	18.71	18.21
EBITDA margin-well completion(	18.93	18.43	18.43	17.93
EBITDA margin-reservoir(%)	26.15	25.95	26.05	26.15

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.7	0.7	0.7	0.6
EV/EBITDA	5.4	5.5	4.9	4.5
EV/IC	0.9	0.8	0.8	0.8
PE*	12.9	30.2	17.2	15.5
P/Book value	0.9	0.9	0.8	0.8
FCF yield (%)	-3.9	7.9	0.0	3.8
Dividend yield (%)	0.0	0.7	1.4	1.5

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 24 Mar 2015

# Business fundamentals

- ▶ SPT generated over 20% ROEs between 2008-2013; on our forecasts it earns mid-single digits over 2014a-2017e
- ▶ Trading multiples expanded from 1x book in 2012 to more than 2x over 2012-2014, before falling in a straight line from mid-2014
- ▶ We think the shares will languish with a 0.5-1x book multiple until the service market starts to expand again

## Investment thesis

While SPT runs an asset-light model, that hasn't protected its P/L from the dislocations created by depreciating emerging market currencies, plunging crude prices and lower industry spending levels. The company has some apparent positives that may yield benefits over the longer term: 1) revenue concentration in oilfield services (OFS) in Kazakhstan and gas services in the Tarim Basin, China's fastest growing gas producing basin, and 2) relatively balanced business across three segments: drilling, well completion and reservoir services. But drilling and well completion revenue growth (particularly in China) have evaporated after the State owned Enterprises began (SOEs) redirecting the lower levels of capital spend and operating spend to captive subsidiaries. Only the reservoir business fares relatively better and with relatively stable margins. This is not enough to support the share price at higher levels.

## 2015 and beyond

### **Management guidance – negative revenue growth expected in 2015, key target is to maintain positive profit**

The company is expecting negative growth in revenue in 2015 given: 1) its reluctance to pick up low-margin projects; and 2) lack of signs of OFS market recovery. The key target is to maintain positive profit and seek to achieve a positive FCF in 2015.

**Backlog.** The current backlog is about RMB800m (excl. the bidding SPT has recently won but not signed), or 40% of our budgeted 2015 revenue of RMB2bn. This is lower than its backlog/sales level in previous years. 66% of the current backlog is from overseas projects and 34% from domestic China; by service segment, reservoir/completion/drilling (incl. workover) account for roughly 40%/30%/30%, respectively.

### **Future growth driver – environmental projects; shale gas related opportunities are below expectation**

The demand for environmental projects (e.g. drilling fluids recycling) is expected to grow going forward and that may become one of SPT's new business drivers. The company has had exposures to such

businesses in Tarim and Sichuan basin with PetroChina and it also sees cooperation opportunities with CNOOC in offshore Bohai and Sinopec in Ordos basin, etc.

China's shale gas related opportunities in 2014 are below SPT's expectation as most of the Sinopec and PetroChina related jobs are awarded to the majors' inhouse services teams and those projects with non-oil majors are mostly delayed. However, they had one breakthrough with China Shenhua in 2014.

#### **Continue to pursue light-asset model**

SPT is cautious in acquiring new assets unless ownership of particular equipment is the prerequisite of winning a new order. SPT's capex in 2015 would be cRMB200m, higher than previous years, as half of the capex is committed to acquire new equipment required by the Halliburton JV and the other half to purchase new equipment required for a few large projects that the company foresee to win in the near term.

SPT is also in the process of screening potential acquisition targets, preferably companies with good market access and technologies.

### **Earnings revision**

We lowered 2015-17e revenue by 9%/15%/21% to factor in management guidance and our view of a slower recovery of the Chinese oilfield services market.

We also materially reduced the segment EBITDA margin as SPT witnessed significant margin squeeze in 2014: drilling/well-completion/reservoir margins dropped 7%/6.7%/4.5% to 18.9%/18.9%/26.1%, respectively. We believe the margin will remain relatively stable at this lower level given that China as well as the international oil majors are suggesting tougher measures to reduce upstream costs.

As a result, the net income for 2015-17e are cut by 77%/61%/59%.

SPT earnings forecast revision table

	New					Old				% Chg			
	2013	2014	2015e	2016e	2017e	2014e	2015e	2016e	2017e	2014	2015e	2016e	2017e
KTG:USD	152.2	179.0	185.0	185.0	185.0	179	185	185	185				
Revenue Growth-%	31.9%	-9.0%	-8.5%	9.8%	6.2%	-16.4%	9.5%	17.7%	13.9%	7%	-18%	-8%	-8%
EBIT Margin-%	17.2%	9.3%	5.3%	7.4%	7.6%	11.1%	12.0%	11.9%	11.2%	-2%	-7%	-5%	-4%
Revenue	2,403	2,187	2,001	2,198	2,333	2,010	2,201	2,591	2,950	9%	-9%	-15%	-21%
EBIT	414	204	107	162	177	222	265	309	330	-8%	-60%	-48%	-46%
Net income	300	116	43	84	95	142	183	216	231	-18%	-77%	-61%	-59%
EPS-RMB	0.19	0.08	0.03	0.06	0.07	0.10	0.12	0.14	0.15	-17%	-72%	-58%	-56%
Revenue-YoY %	32%	-9%	-9%	10%	6%	-16%	10%	18%	14%				
Net Income-YoY %	21%	-61%	-63%	97%	13%	-53%	29%	18%	7%				
EPS-Yoy %	6%	-59%	-57%	76%	11%	-51%	27%	17%	7%				
Net income margin-%	12.5%	5.3%	2.1%	3.8%	4.1%	7.0%	8.3%	8.4%	7.8%				
BPS-RMB	1.17	1.16	1.19	1.24	1.28	1.21	1.30	1.42	1.53				
ROE-%	17.8%	6.5%	2.4%	4.5%	4.9%								
DPS-RMB	0.050	0.000	0.007	0.014	0.016	0.024	0.030	0.036	0.039				
Payout-%	25%	0%	26%	26%	26%	25%	25%	25%	25%				
Yield-%	4.9%	0.0%	0.7%	1.4%	1.6%	2%	3%	3%	4%				
Current Price-HKD			1.28				1.34						
HSBC Target Price-HKD			1.10				1.50						
HSBC Upside-%			-14%				12%						
HSBC Current PB (x)	0.87	0.88	0.86	0.83	0.80								
HSBC Target PB (x)	0.75	0.76	0.74	0.71	0.68								
Target P/B vs. consensus		-0.5	-0.5	-0.4	-0.4								
Consensus TP - HKD			1.78				2.48						
Cons Upside/(downside)-%			39%				85%						
HSBC/Consensus			-38%				-40%						
Consensus Target PB (x)	1.2	1.2	1.2	1.1	1.1	1.6	1.5	1.4	1.3				
HSBC EPS-RMB	0.19	0.08	0.03	0.06	0.07	0.10	0.12	0.14	0.15				
Consensus EPS-RMB			0.10	0.14	0.12	0.20	0.23	0.28	N.A.	-100%	-56%	-52%	NA
HSBC/Consensus			-67%	-56%	-47%	-52%	-48%	-50%					

Source: Company data, Bloomberg, HSBC estimates

## 2014 earnings review

**2014 net profit was RMB116.2mn, 61% lower than 2013** and missed HSBCe and consensus estimates by 18/13%. The y-o-y decline was mainly a result of 1) oil majors cutting E&P capex amid an oil price slump; 2) the KZT devaluation in February 2014 led to a one-off RMB60m loss; and 3) expansion-related cost escalation. Reported EPS was RMB0.076/sh and no dividend is proposed for 2014.

**2014 revenue was RMB2.2bn, 9% lower yoy.** Income from drilling and well completion businesses have decreased at double-digits while oil reservoir's revenue remained solid. Geographic revenue mix remained largely unchanged as domestic revenue shrank 9.5% amid capex cuts and overseas revenue dropped 8.6% due to KZT depreciation.

**Profit margin under compression.** The operating profit declined 50% yoy to RMB204mn as a result of lower profit margins. The EBITDA margins for the drilling, well-completion and reservoir businesses were 18.9%/18.9%/26.1% respectively, down from 25.9%/25.6%/30.6% in 2013, on the combination of lower revenues and higher expenses such as costs in raw material and staffing.

**Effective tax rate increased to 28.7% from 20.8% in 2013** mainly due to increase of certain non-deductible expenses/

## Valuation and risks

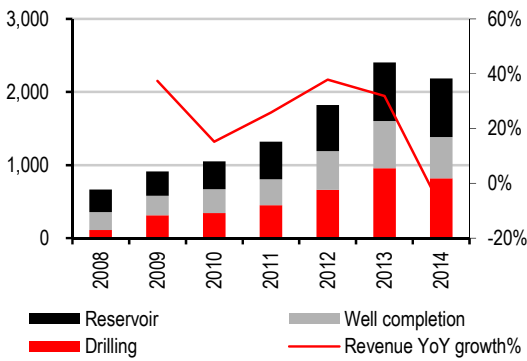
We establish a new rating: Hold vs. prior Neutral(V) and set a fair value TP at HKD1.10 (vs. HKD1.50 previously). Our new target price is established by applying a 0.75x PB to our 2015e BVPS of HKD1.46. At current prices, SPT is trading at c.0.7x-0.9x PB, which appears to be close to the historical trough valuation range. But we believe key catalysts are lacking to move the shares out of this range, and that it will take a clearly visible change in the operating conditions and earnings outlook to move the shares. Our new target price is c38% below consensus, and we expect that the consensus earnings and the share price will adjust lower to reflect the latest update on operating conditions and profitability.

**Key upside risks:** 1) major recovery in oil prices leading to OFS market recovery; 2) further contract wins; 3) a deeper partnership with Halliburton, (e.g. direct equity investment); 4) positive prospects in China's shale gas industry and 5) short covering.

**Key downside risks:** further weakness of KZT; 2) more insourcing by Chinese oil majors.

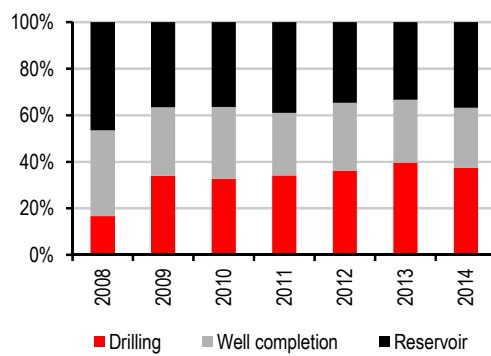
## SPT 2014 financials

SPT revenue breakdown by segment (RMBm) and yoy growth (%), RHS



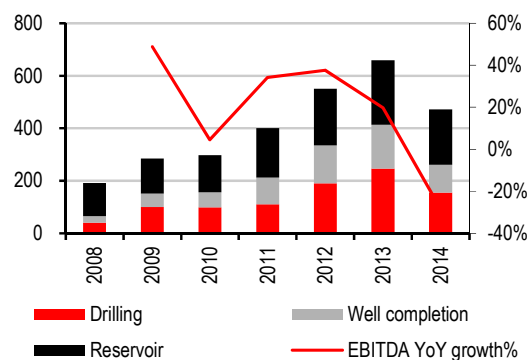
Source: Company data, HSBC

SPT revenue breakdown by segment (%)



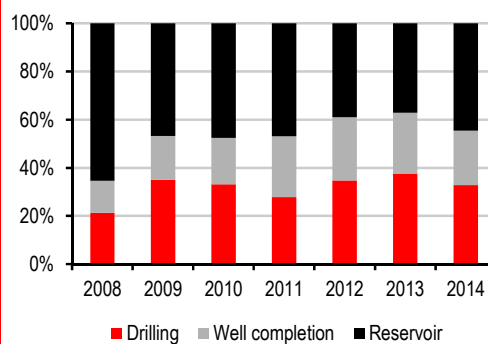
Source: Company data, HSBC

SPT EBITDA breakdown by segment (RMBm) and yoy growth (%), RHS



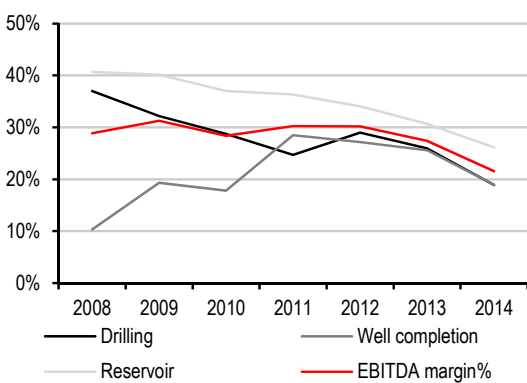
Source: Company data, HSBC

SPT EBITDA breakdown by segment (%)



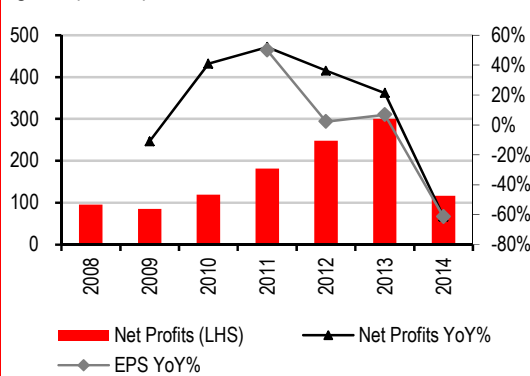
Source: Company data, HSBC

SPT EBITDA margin by segment (%)



Source: Company data, HSBC

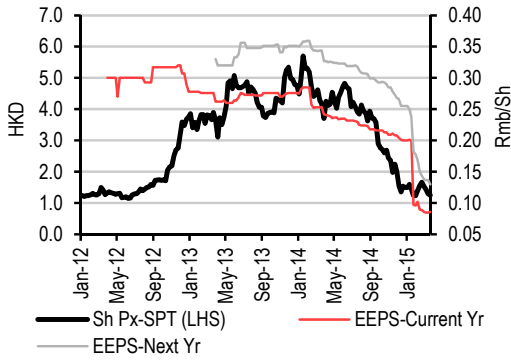
SPT net profit (RMBm, LHS) vs. net profit and EPS yoy growth (%), RHS



Source: Company data, HSBC

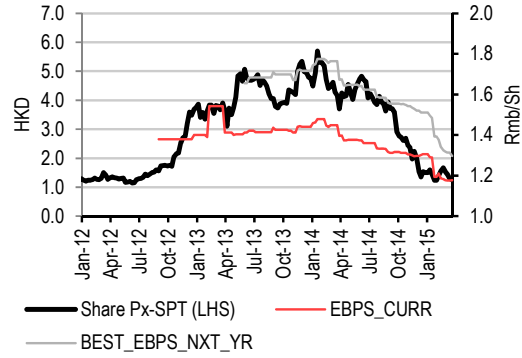
## SPT key valuation parameters

Share price vs consensus EPS



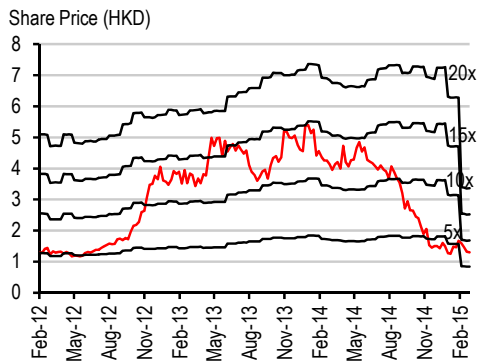
Source: Bloomberg

Share price vs consensus BPS



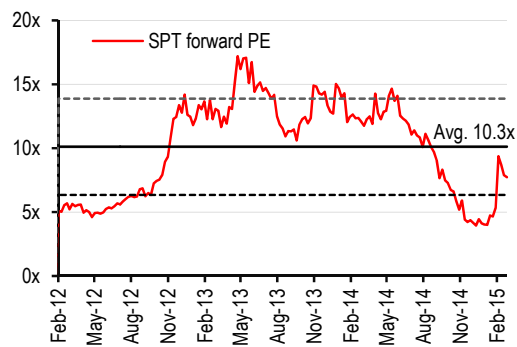
Source: Bloomberg

SPT P/E band



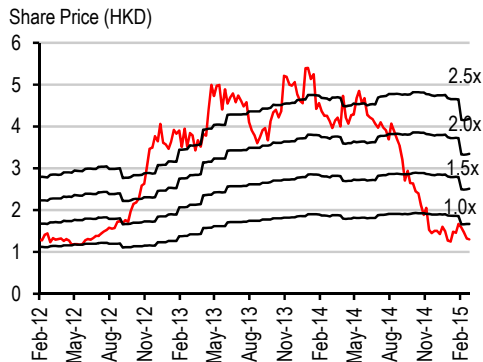
Source: Thomson Reuters Datastream

SPT long-term P/E



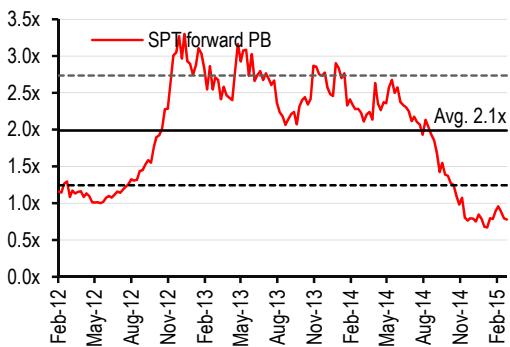
Source: Thomson Reuters Datastream

SPT P/B band



Source: Thomson Reuters Datastream

SPT long-term P/B



Source: Thomson Reuters Datastream



# Disclosure appendix

## Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Thomas C. Hilboldt, Tingting Si and Hanyu Zhang

## Important disclosures

### **Equities: Stock ratings and basis for financial analysis**

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations and that investors utilise various disciplines and investment horizons when making investment decisions. Ratings should not be used or relied on in isolation as investment advice. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations and therefore investors should carefully read the definitions of the ratings used in each research report. Further, investors should carefully read the entire research report and not infer its contents from the rating because research reports contain more complete information concerning the analysts' views and the basis for the rating.

### **From 23rd March 2015 HSBC has assigned ratings on the following basis:**

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

### **Prior to this date, HSBC's rating structure was applied on the following basis:**

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands were classified as Neutral.

\*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

## Rating distribution for long-term investment opportunities

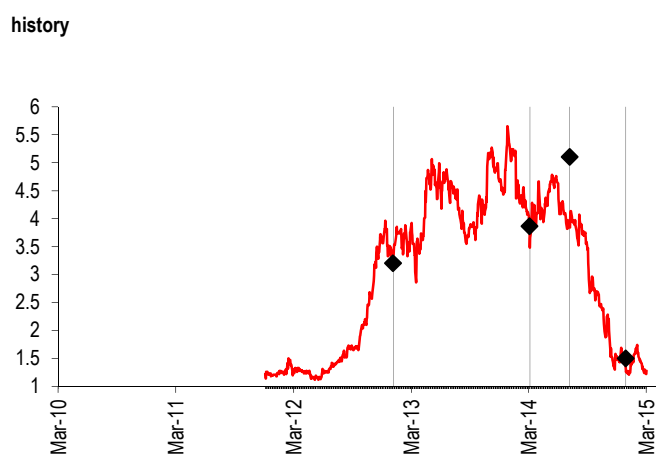
As of 24 March 2015, the distribution of all ratings published is as follows:

<b>Buy</b>	41%	(30% of these provided with Investment Banking Services)
<b>Hold</b>	39%	(28% of these provided with Investment Banking Services)
<b>Sell</b>	20%	(20% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

## Share price and rating changes for long-term investment opportunities

SPT Energy Group (1251.HK) Share Price performance HKD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Underweight (V)	27 January 2013
Underweight (V)	Neutral (V)	27 March 2014
Neutral (V)	Overweight (V)	29 July 2014
Overweight (V)	Neutral (V)	19 January 2015
Target Price	Value	Date
Price 1	3.20	27 January 2013
Price 2	3.86	27 March 2014
Price 3	5.10	29 July 2014
Price 4	1.50	19 January 2015

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
SPT ENERGY GROUP	1251.HK	1.28	24-Mar-2015	7

Source: HSBC

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