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Giken Sakata (S) Limited

Ready to Astound the Market

Following our previous report on the Indonesia Oil E&P Sector (Value within the "Old Well" Programme, 7 May 2014), we decided to take a deeper look at Giken Sakata (S) which had recently acquired a 53.7% stake in Cepu Sakti Energy Pte Ltd. The latter focuses on producing oil from mature oilfields in Indonesia under the local co-operative agreements. Such contracts have several investment merits like 1) the exploration risk is lower, 2) the capex per well is only about US$150k, 3) the profit margin is higher relative to traditional PSC/KSO contract, 4) relative short payback period of less than five months and lastly 5) the model is replicable and there are currently about 14,000 of such mature wells in Indonesia. If Cepu is able to execute its strategy well and able to extend its assets' operating rights and secure new operating rights, we reckon that Giken may be worth about S$0.450 per share. ***Potential Gem.***

Company Summary: Giken ventured into the oil and gas arena in view of the challenging environment within the precision manufacturing and engineering sector. The company acquired a 53.7% stake in Cepu for S$48m and the acquisition was funded via cash from private placement and share issuance.

About Cepu and the Financials: Cepu has the right to operate and produce oil from three Indonesian oilfields. Two of the fields have a combined 2P reserve of 9.6m barrels of crude oil worth a best value of about US$195m. The right to a third field (has 91 wells) was acquired in June 2014 and the reserve estimates are in the process of being updated. Cepu now has two rigs operating in its assets and capable of completing four wells per month, each with an estimated average output of 50 barrels per day. The projected profit margin per barrel of oil is around 38% and Cepu is expected to generate PAT of >US$30m in FY18 to FY20.

Risks: Though we reckon that Cepu has many exciting attributes, we reckon that investors should take note of 1) our valuation is largely dependent on their ability to extend its assets' operating rights and secure new operating rights, 2) Cepu has to sell their output to Pertamina who has the right to fix the selling price (subject to 70% of Indonesia Crude Price) and 3) Cepu has a limited operating record.

Potential Gem

- Potential Price S$0.450
- Last Price S$0.325

Main Activities

Giken Sakata (S) Limited (Giken) is a integrated contract manufacturer that provides precision machining and engineering services mainly for the electronic industry. Recently, the company intends to diversify into the O&G sector via acquiring 53.7% stake in Cepu Sakti Energy Pte Ltd (Cepu).

Financial Highlights		
(Y/E Aug)S$m	**FY12**	**FY13**
Revenue	89.5	127
Gross Profit	8.78	9.49
Profit after Tax	0.37	0.45
EPS (S cts)*	0.28	0.34
Current Assets	24.7	21.4
Non-Current Assets	5.59	5.03
Current Liabilities	20.0	17.2
Non-Current Liabilities	2.35	0.49
Equity	8.0	8.7

Source: Company

Key ratios (FY13)	
P/E	NM
P/BV	17.9
Return on Equity	3.9%
Liabilities / Equity	2.0
Current Ratio	1.24

Source: Company

Indexed Price Chart

Green (FSSTI)
Black (Giken)

Source: Bloomberg

52wks High-Low	*S$0.390/S$0.034*
Number of Shares	*473 m*
Market Capitalization	*S$154m*

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Company Background: Giken Sakata (S) Limited (Giken) was incorporated in December 1979 (in Singapore) and was listed on the then SESDAQ (now known as Catalist) in February 1993. Giken positions itself as an integrated contract manufacturer that provides precision machining and engineering services for the manufacturing and assembly of finished products and semi-finished components for the electronic industry. Some products produced by Giken include printed circuit boards, precision micro shafts, turned parts, plastic injection molded parts and others. Giken has plants spanning Singapore, Indonesia and China with bulk of the sales going to Europe and Japan. Going forward, the company is looking at entering into more niche OEM jobs with established electronic MNCs and lift its utilization rate which is currently around 70%-75%. Giken recorded revenue of S$90m and S$137m and PAT of S$373k and S$451k for FY12 and FY13 respectively.

Inside Giken's FY13 annual report, the Chairman Mr. Chin Siew Gim commented about concerns over the uncertain state of the European and American markets while the CEO Mr. Tan Kay Guan expressed the need to achieve higher resource optimization to cope with higher wages. The challenging industry environment prompted the management to seek alternative routes to boost profitability and the call for diversification led to the acquisition of a 53.7% stake in Cepu Sakti Energy Pte Ltd (Cepu).

The purchase consideration amounts to S$48m and will be paid via 1) approximately S$25.2m in cash and 2) the issue and allotment of new shares of the company for the remaining consideration at the issue price of S$0.30 per share. The cash consideration will be split into two tranches - the first tranche of S$15m was paid recently while the second tranche of S$10.2m will be paid on a later date, after evidence of the renewal of oil production agreement for the Tungkul field is attained.

About Cepu Sakti Energy Pte Ltd: Cepu is headquartered in Singapore in 2002 and owns 95% of PT Cepu Sakti Energy. The latter has the right to operate and produce oil from three oilfields; in the Tungkul field in Blora, Central Java and the Dandangilo-Wonocolo fields (D&W fields) in Bojonegoro, East Java and the Kawengan field, also in Bojonegoro, East Java. The fields have a total of 230 old well sites, of which 14 are recently operational and producing about 670 barrels of crude oil per day in the month of June 2014. Cepu's strategy is to drill a new well beside the old well and increase the wells' depth with the aim of improving the flow rate.

According to the report prepared by Senergy Oil & Gas (Singapore) Pte. Ltd. dated 26 May 2014, the former two fields have a combined 2P crude oil reserve of 9.6m barrels and may be worth a best value of about US$195m based on 10% discount rate. The value will grow to US$222m if the existing agreements expire in 2028.

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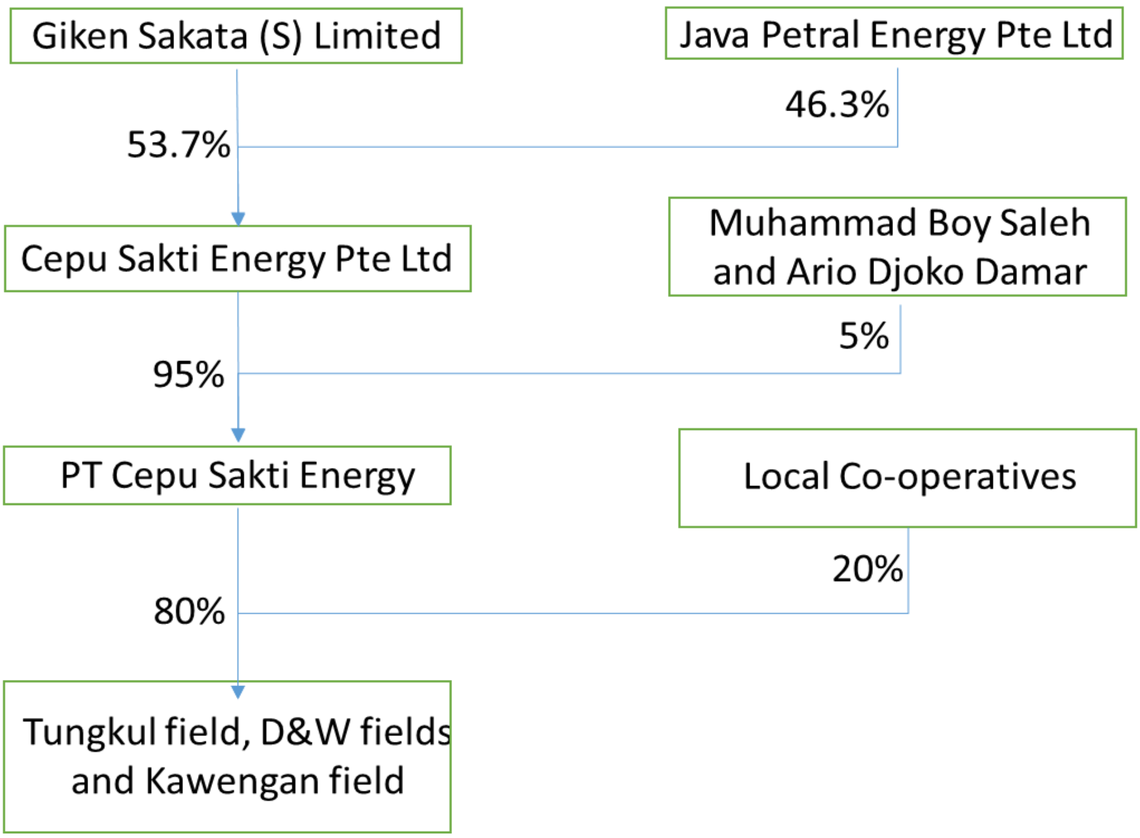
Pursuant to the two oilfields, Cepu also entered into a cooperation agreement with KUD Sumber Pangan in June 2014 where it was granted the right to manage at least 91 old oil wells in the Village Kawengan, District Kedewan, Bojonegoro (Kawengan field). Cepu will fund the drilling/well deepening and exploration expenses in return for a substantial proportion of the revenue. We reckon that the terms of this cooperation agreement is similar to that of the previous two fields.

Figure 1: Statistics from Senergy Oil & Gas (Singapore) Pte. Ltd

Dandangilo-Wonocolo and Tungkul Fields (As of 30 April 2014)		
Oil (MMstb)	Gross attributable to License	Net attributable to Issuer
1P	5.6	4.4
2P	9.6	7.6
3P	13.2	10.4
	NPV10 (US$mn) 2020/2022 expiry	NPV10 (US$mn) 2028 expiry
Low	96	101
Best	195	222
High	281	335

Source: Company

Figure 2: Corporate Structure after Acquisition



Source: Company, Voyage Research

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Figure 3: Location of the Oilfields

Source: Google Map, Voyage Research

The Agreements Involved in the "Old Well" Programme: A traditional PSC/KSO contract usually only involves Pertamina (Indonesia State Oil and Natural Gas Mining Company) and the relevant O&G company. For the "old well" programme, there is 1) a Mother agreement which is granted by Pertamina to the local co-operatives (local KUD/BUMD) for the oil production and 2) a cooperation agreement which is granted by the local co-operatives to the O&G company.

Though the Tungkul field's Mother agreement is expiring in 14 months' time, Cepu has received a comfort letter from Pertamina that the agreement will be extended (six months prior the end of the existing contract) for another five years. Management is also confident about extending the Mother agreement for the D&W fields in October 2017.

Figure 4: Existing Agreements for Cepu's Fields

	Fields	Date of Mother Agreement	Duration (yrs)	Date of Cooperation Agreement	Duration (yrs)
Tungkul Field	30	Nov-10	5	Feb-13	10
D&W Fields	109	Oct-12	5	Mar-13	10
Kawengan Field	91	May-14	5	Jun-14	10

Source: Company, Voyage Research

Funding the Acquisition: In order to fund the 53.7% stake in Cepu, Giken had issued 80m shares at an issue price of S$0.30 per share. The placement was fully subscribed and completed on 10 Sep 2014. The net proceed was about S$22.7m and the bulk of it was used to finance the first tranche cash consideration of the acquisition. A shareholder loan of about S$6.25m was also extended to Cepu (5% interest for 3 years) for their operating activities.

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What Production Number can We Expect from Cepu?: Cepu attained the first cooperation agreement around March 2013 and we reckon that the entity spent about the first six months exploring the assets and deciding which sites to recover first. The first rig was probably brought in around Nov 2013 and capable of completing two rigs per month – which leads to the 14 producing rigs as of end June 2014. The numbers suggest that 1) each rig can complete a well in around two weeks and 2) each well can produce about 50 barrels of crude oil per day. The drilling of each well may cost about US$150k and the recovery cost per barrel of crude oil is about US$16.40. Cepu is currently bringing in a second rig to speed up the recovery process.

Giken has a total of 230 old wells (including the newly secured Kawengan field) and if we assume 50 barrels of crude oil production per day, the entity can yield up to 6,700 barrels of crude oil per day during its peak production. We applied a 20% annual output decline to the production numbers as they are brown fields (mature fields).

What We Like About Cepu?: Cepu's "old well" strategy has several investment merits like 1) the "exploration" risk is lower as Cepu will drill new wells beside the old wells (which were previously producing) and the amount of capex per well is only about US$150k, 2) the amount payable to the local authorities is lesser than the traditional PSC/KSO contracts and Cepu is able to have a profit margin of more than 35%, 3) the wells have a relative short average payback period of less than five months and 4) Cepu's model is replicable and there are currently about 14,000 of such mature wells in Indonesia.

Valuation and Forecast: We applied the following assumptions for our valuation of Cepu: 1) the company will recover 40 wells per year from now till FY19, 2) each well will produce 50 barrels of crude oil on the onset and decline at a rate of 20% per annum, 3) selling price to Pertamina is conservatively fixed at US$57 per barrel, 4) 20% of the revenue is given to the local co-operatives, 5) operating expense of 36% of revenue and 25% tax on PBT and 6) WACC of 10%. We added a US$ 20m residual value for the existing agreements as Cepu may be able to extend the contract term and extract more resource out of the wells. We also included a US$100m premium on Cepu as the company is able to replicate this strategy to other areas and generate higher top line and bottom line.

Giken's 51% stake in Cepu amounts to approximately S$199m and we value the existing business at 1.5X P/B or S$13m. We then discount the total value with 472.6m shares – taking into account the upcoming placement and share to be issued to Cepu. The resultant price is S$0.450 per share.

Figure 5: Valuation of Cepu

	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
No. of Operating Wells	20	60	100	140	180	220	220	220	220
Avg No. of Wells in Ops		40	80	120	160	200	220	220	220
Barrels of oil per well		50	45	40.7	36.9	33.6	26.9	21.5	17.2
Barrels of oil per day		2000	3600	4884	5904	6720	5918	4730	3784
Operating Days		360	361	362	363	364	365	366	367
Total Output		720,000	1,299,600	1,768,008	2,143,152	2,446,080	2,160,070	1,731,180	1,388,728
Selling Px (US$) to Pertamina		57	57	57	57	57	57	57	57
Revenue (US$mn)		41.0	74.1	100.8	122.2	139.4	123.1	98.7	79.2
Amt to Cepu		32.8	59.3	80.6	97.7	111.5	98.5	78.9	63.3
Operating Profit		21.0	37.9	51.6	62.5	71.4	63.0	50.5	40.5
PAT		15.8	28.4	38.7	46.9	53.5	47.3	37.9	30.4
Discount Rate		0.91	0.83	0.75	0.68	0.62	0.56	0.51	0.47
FCF to Cepu		14.33	23.51	29.07	32.04	33.24	26.69	19.44	14.18
Explicit Value to Cepu (US$m)		193							
Residual Value of Assets		20				WACC	10%		
Premium for possible new assets		100							
Value of Cepu (US$m)		313							

Source: Voyage Research

Figure 6: Valuation of Giken

	Value S$m	
Giken's 51% stake in Cepu	199.28	
Value of Giken Existing Assets (1.5X P/B)	13.05	
Total Valuation	212.33	
Shares Enlarged Share Outstanding	472.60	
Value per Share	0.449	~0.450

Source: Voyage Research

Risks and Concerns: Though we are sanguine about Giken's outlook, we caution investors that 1) Cepu's valuation is largely dependent on their ability to extend the assets' operating rights and secure new operating rights, 2) the output is currently sold to PT Pertamina EP who has the right to fix the selling price and exchange rate and 3) Cepu has a limited operating record.

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Rating Definition:

True Gem – This stock is greatly underappreciated by the market, with more than 50% upside opportunity from its current share price.
Convincing Gem – This stock is underappreciated by the market, with more than 30% upside opportunity from its current share price.
Potential Gem – This stock is not fairly valued by the market, with more than 15% upside opportunity from its current share price.
Potential Stone – This stock is overrated by the market, with more than 1% downside risk from its current share price.
Probable Stone – This stock is overvalued by the market, with more than 25% downside risk from its current share price.
Real Stone – This stock is seriously overvalued by the market, with more than 40% downside risk from its current share price.

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