23 July 2013

OIL & GAS SERVICES

VSA capital

Initiation of Coverage

Independent Research

Kentz Corporation

BBG Ticker: KENZ LN *Price: 423p* *Mkt Cap: £499m* ***BUY***

Year to December	Revenue (US$m)	EBITDA* (US$m)	PBT (US$m)	EPS (US$)	DPS (US$)	EV/Sales (x)	EV/EBITDA (x)	P/E (x)	Div Yield (%)
2011A	1,368	98	79	0.49	0.123	0.41	5.79	13.19	1.9%
2012A	1,413	119	105	0.58	0.145	0.40	4.77	11.13	2.2%
2013E	1,524	124	114	0.66	0.165	0.37	4.55	9.81	2.5%
2014E	1,648	134	124	0.73	0.182	0.34	4.22	8.84	2.8%
2015E	1,806	141	131	0.78	0.194	0.31	4.00	8.33	3.0%

NOTE: **Including Kentz's share of JV profits.* ***SOURCE****: Company, VSA Capital estimates.*

Diversify and Conquer

Encouraging Signs for the Sector

H1 2013 has seen poor performance throughout the oil and gas services sector, due to lower oil demand restricting investment in projects. H2 should see market conditions beginning to improve, however, driven by increased demand globally. Thus, we are optimistic for the sector in H2, and expect to witness signs of recovery across the board.

Global Reach Reduces Risk

Kentz has a well-established presence in Russia, the Middle East and Africa, while the Canadian and Australian businesses are expanding vigorously. Kentz grows its geographic footprint by following big projects from existing clients - such as ExxonMobil and RD Shell - across the globe; while simultaneously bringing on board new clients in new locations, such as Imperial Oil in Canada.

Sustained, Blue-Chip Client Base

Kentz has an excellent record of delivering on projects worldwide. As a result, the blue-chip client base comes back to Kentz with new contracts time and time again. Kentz has a strong backlog of US$2.8bn, and a far bigger pipeline of prospects valued at US$14bn.

Kentz won its first overseas contract with Fluor in 1977, and the two have retained a strong relationship ever since. ExxonMobil is also an extremely valuable client, providing work for Kentz annually with global reach. Other key clients include Chevron, Sasol, Qatar Petroleum, RD Shell and Vale.

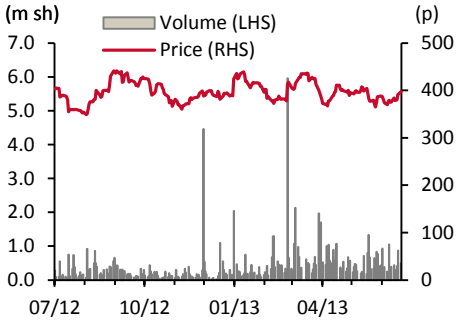
Recommendation and Target Price

We have blended the results of our DCF model and peer group analysis, to obtain a target price of 590p, and initiate coverage of Kentz with a **BUY** recommendation.

Company Description

Global engineering specialist solutions provider, operating in 30 countries worldwide, providing EPC, Construction and Technical Support Services to clients in the energy and resources sectors.

One Year Price Performance



Price % chg	1mn	3mn	12mn
	+9.4%	+13.6%	+5.1%

12mn high/low: 441p/349p

SOURCE*: FactSet, as of 19 July 2013 close.*

Market:	LSE Main
Price target:	590p
Shares in issue:	117.8m
Free float:	81.6%
Net cash (Dec 12):	US$196m
Enterprise value:	US$565m
Next news:	H1 results, 27 August 2013

Major shareholders	
Kerbet Ltd	13.5%
Standard Life Investments	7.1%
Legal & General Asset Mngmnt	6.5%

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Valuation and Recommendation

Peer Group Analysis

On the basis of peer group analysis, it can easily be seen that Kentz is undervalued within the sector on an EV/EBITDA basis. The peer group average 2013E EV/EBITDA is 7.5x and the mean 2014E EV/EBITDA is 6.1x; thus, based on our EBITDA forecasts for Kentz, we calculate a derived enterprise value of roughly £737m, or 630p per share, using these metrics.

Working on the assumption that Kentz should ultimately align with its peer group on an EV/EBITDA basis, the stock currently appears good value compared to many alternatives within the oil and gas services field.

Peer Group Analysis

Company	FS Ticker	Share Price (£)	Market Cap (£m)	Enterprise Value (£m)	2013E EBITDA (£m)	2014E EBITDA (£m)	2013E EV/EBITDA	2014E EV/EBITDA
Kentz Corp. Ltd.	**KENZ-GB**	**4.23**	**499.6**	**371.2**	**81.4**	**87.8**	**4.6**	**4.2**
Aker Solutions	AKSO-NO	9.71	2,626.3	3,848.0	493.8	639.1	7.8	6.0
AMEC	AMEC-GB	10.56	3,252.5	3,290.6	372.4	414.4	8.8	7.9
Daelim Industrial Co.	000210-KR	47.15	1,640.7	2,163.4	345.0	388.3	6.3	5.6
John Wood Group	WG-GB	9.02	3,364.2	3,449.8	387.1	431.9	8.9	8.0
Maire Tecnimont	MT-IT	0.59	73.5	407.2	76.3	66.1	5.3	6.2
Petrofac	PFC-GB	12.94	4,475.8	4,259.2	660.9	782.9	6.4	5.4
Saipem	SPM-IT	13.33	5,883.7	6,138.0	669.5	1,513.1	9.2	4.1
Subsea 7	SUBC-NO	12.46	4,131.6	5,100.8	632.0	979.2	8.1	5.2
Technip	TEC-PAR	71.21	8,049.7	9,058.1	1,010.7	1,218.9	9.0	7.4
TMK	TRMK-RU	1.72	1,485.0	3,983.7	688.6	751.2	5.8	5.3
Weatherford Int'l	WFT-US	9.33	7,146.1	12,968.2	1,929.8	2,303.2	6.7	5.6
						Peer Group Average	**7.5**	**5.9**

	2013E	2014E
Ave. peer group EV/EBITDA	7.5	6.1
Derived Enterprise Value (£m)	608.6	532.7
Net debt adjustment (£m)	-128.5	-128.5
Derived market cap (£m)	737.1	661.2
Actual market cap (£m)	499.6	499.6
% difference	*48%*	*32%*

***SOURCE**: FactSet, VSA Capital estimates.*

DCF Valuation

Using a DCF valuation model [10% Weighted Average Cost of Capital (WACC), 3% Terminal Growth Rate (TGR)] we obtain a target price of 550p, thus corroborating our aforementioned **BUY** recommendation. A revenue growth rate of c8% is projected for 2013, spurred on by TSS business expansion, particularly in the Canadian oil sands.

JV profits, namely earnings from the Gorgon Project, a major gas development in Western Australia, are an important contributor to the growth of Kentz's income stream; although such profits are not accounted for as company revenue at present. Kentz's share of JV profits is expected to rise to around US$40m in 2013, before potentially rising still further to US$45m in 2014 and 2015. Gorgon is currently Kentz's only significant JV, although the company is open to entering into others.

Discounted Cash Flow Valuation

Year End December (US$m)	2013E	2014E	2015E
EBIT	**73**	**79**	**86**
Depreciation & Amortisation	10	10	10
Share of JVs profit/ loss	41	45	45
EBITDA	**124**	**134**	**141**
Share based payments	3	3	3
Working capital movements	10	0	0
Operating CF (adj for JV profits)	**138**	**137**	**145**
Capex	(5)	(5)	(5)
Net Interest	(1)	(1)	(1)
Cash Taxes	(29)	(32)	(35)
FCF	102	100	104
Discount factor	0.91	0.83	0.75
Discounted FCF	**93**	**82**	**78**

NPV (£m)	**238**
TV (£m)	501
EV (£m)	738
Net Cash/(Debt)	(83)
Fair Value (£m)	**655**
Shares Outstanding (m)	118
Fair Value Price (p)	**550**
Upside/(Downside) to SP	**30%**
Rating	**BUY**
WACC (%)	**10%**
TGR (%)	**3%**

***SOURCE**: VSA Capital estimates.*

Kentz in Brief

Kentz is a contractor to the natural resources sector, providing services across the value chain to a wide range of geographies and industries. The company is divided into three business units: Engineering, Procurement and Construction (EPC); Construction; and Technical Support Services (TSS).

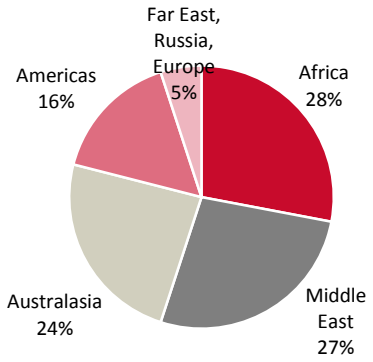
- Under the EPC umbrella, the Kentz in-house team designs, engineers and builds complex facilities, globally.
- The Construction unit covers multi-discipline construction contract execution, focussing on the provision of structural, mechanical, electrical, instrumentation and piping services.
- Through the TSS business, Kentz offers a range of services for capital projects. TSS spans front-end and detailed engineering, project and construction management, and completions and commissioning of major energy plants.

Revenue Generation

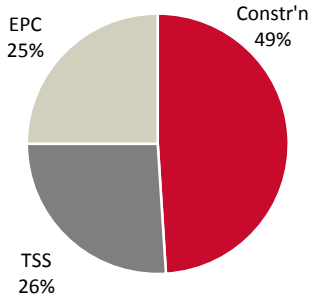
Kentz's revenue streams for 2012 are shown below, split by geography, business unit and industry. The company's mining industry projects are concentrated in southern Africa, specifically Mozambique and Madagascar; while petrochemicals work is focussed in the Middle East.

Revenue Breakdowns, 2012A

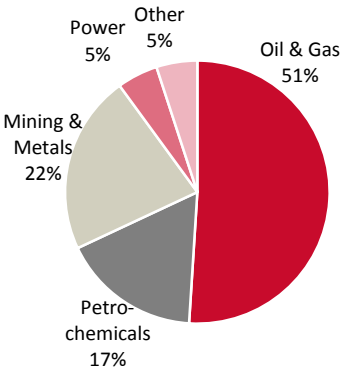
Geography



Business Unit



Industry



SOURCE: *Company data.*

By Geography

Of the regions in which Kentz is active, the Australian pipeline appears most promising. This is echoed in the company backlog, with 59% concentrated in Australia. All three of Kentz's business units are active in the country, concentrating on service provision to LNG projects. The Gorgon LNG Project, in Western Australia, on which Kentz JVs have been awarded nearly US$3bn-worth of work, has been a particularly crucial contributor to company earnings growth.

Canada is another region to watch closely, with operations going from a standing start in 2008, to account for 16% of company revenue in 2012. Oil sands projects have been the particular focus, with Kentz having won around US$300m of Canadian oil sands projects over the last few months. Kentz is forming a strong bond with client Imperial Oil, known for its holdings in the Alberta oil sands, and this relationship should continue to flourish.

By Business Unit

For 2013, EPC earnings are expected to remain flat, while the construction business should exhibit double-digit growth. TSS should expand aggressively, experiencing c30% earnings growth. EPC margins tend to be 10-15%, Construction margins 9-12%, and TSS margins around 20%. Thus a rise in the proportion of TSS work might be expected to lead to raised margins.

However, the proportion of company backlog comprising reimbursable contracts has now risen to 80%, from what has been traditionally a much lower figure. Reimbursable contracts tend to have lower margins than the unit-rate and lump-sum alternatives, while being less risky. Thus, the skewing of the contract portfolio towards reimbursable work may be expected to offset margin rises from TSS, leaving overall gross profit margins at around 12%.

We note, however, that reimbursables will not always account for such a high proportion of contracts.

Revenue Model by Geography

Year End December (US$m)	2011A	2012A	2013E	2014E	2015E
Middle East	**420**	**425**	**484**	**484**	**524**
Revenue Growth	*-5%*	*1%*	*14%*	*0%*	*8%*
Proportion of Global total	29%	27%	27%	25%	25%
Africa	**572**	**444**	**431**	**465**	**482**
Revenue Growth	*116%*	*-22%*	*-3%*	*8%*	*4%*
Proportion of Global total	39%	28%	24%	24%	23%
Far East, Russia and Europe	**65**	**73**	**78**	**81**	**88**
Revenue Growth	*-52%*	*13%*	*6%*	*4%*	*8%*
Proportion of Global total	4%	5%	4%	4%	4%
Australasia	**338**	**374**	**502**	**562**	**629**
Revenue Growth	*80%*	*11%*	*34%*	*12%*	*12%*
Proportion of Global total%	23%	24%	28%	29%	30%
Americas	**74**	**247**	**299**	**345**	**373**
Revenue Growth	*159%*	*235%*	*21%*	*15%*	*8%*
Proportion of Global total	5%	16%	17%	18%	18%
Total Revenue Including JVs	**1,469**	**1,563**	**1,794**	**1,938**	**2,096**
Less: Revenue from Equity Accounted JVs	(101)	(151)	(270)	(290)	(290)
Total Revenue	**1,368**	**1,413**	**1,524**	**1,648**	**1,806**
Revenue Growth	*29%*	*3%*	*8%*	*8%*	*10%*

***SOURCE**: Company data, VSA Capital estimates.*

Revenue Model by Business Unit

Year End December (US$m)	2011A	2012A	2013E	2014E	2015E
Specialist EPC	**448**	**395**	**400**	**400**	**420**
Revenue Growth	*33%*	*-12%*	*1%*	*0%*	*5%*
Construction	**710**	**759**	**861**	**925**	**971**
Revenue Growth	*50%*	*7%*	*13%*	*7%*	*5%*
Technical Support Services	**311**	**409**	**533**	**613**	**705**
Revenue Growth %	*26%*	*32%*	*30%*	*15%*	*15%*
Less: Revenue from Equity Accounted JVs	(101)	(151)	(270)	(290)	(290)
Total Revenue	**1,368**	**1,413**	**1,524**	**1,648**	**1,806**
Revenue Growth	*29%*	*3%*	*8%*	*8%*	*10%*

***SOURCE**: Company data, VSA Capital estimates.*

Acquisitive Ambitions

Kentz's sees engineering capacity as its comparative weak spot, and is thus looking to strengthen this area. The current engineering team is 600-strong, but the company perceives a need for more process engineers. Management have been aggressively seeking engineering businesses to acquire, whittling the list down from thousands of companies to just four or five contenders. Kentz is prepared to spend up to US$160m acquiring one or two businesses, using US$80m of its own cash not required for operations, and US$60-80m of borrowings. It will be considered something of a disappointment internally if an acquisition has not been made by the year end.

Services Market Overview

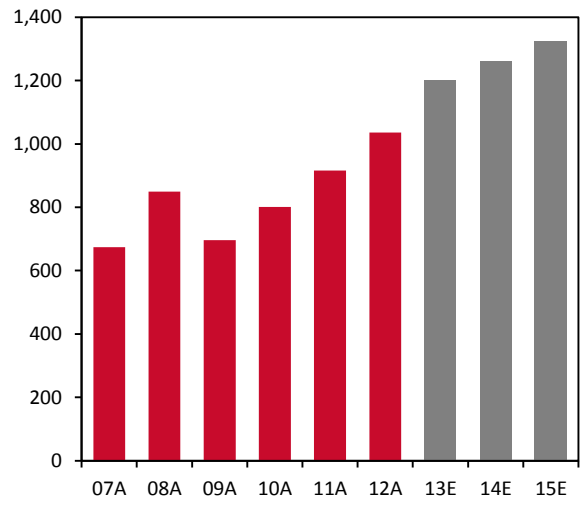
Oil and Gas

Capital spending growth in the oil and gas industry is anticipated to slow towards the end of the decade, to around 5% per annum, in the wake of the rapid expansion observed since the turn of the Millennium. Although strong annual growth of c15% may be achievable in 2013, a drop to low-single figure capex annual growth rates (GAGRs) is then expected. This compares with the near-20% CAGRs seen over the last decade.

Flat to bearish oil price forecasts for the next two years are principally driving the slower growth outlook. While world energy demand grows and the current pricing environment remains strong, without hitting the highs of 2008, scepticism is building over whether this level is sustainable. In May 2013, the EIA predicted that Brent crude (the benchmark grade for over half the world's crude oil) will average US$105.89/bbl for 2013, falling marginally to US$100.75/bbl in 2014. By comparison, Brent crude yearly averages reached historic highs in both 2011 (US$111.26/bbl) and 2012 (US$111.76/bbl). VSA's own view is for a Brent average of US$100/bbl for 2013.

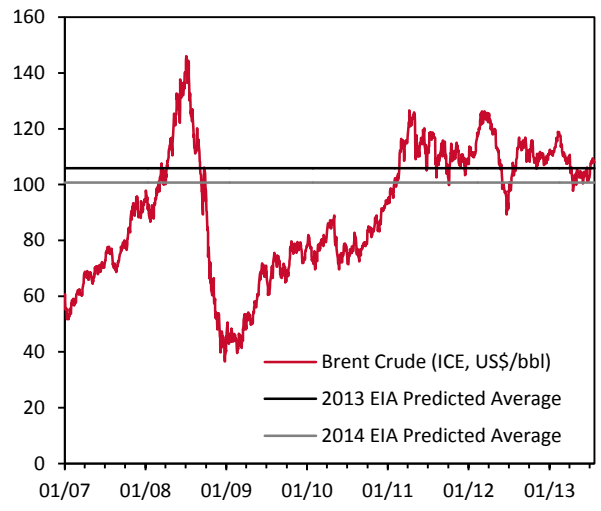
Whereas some within the industry consider US$100/bbl a sustainable oil price benchmark going forward, others are cautioning that a fall to around US$80/bbl may occur, the low of a short duration cycle of under two years. Commodity price upside pivots on Middle Eastern political developments and industry underinvestment; while sources of downside potential include market slowdown and unconventional oil and gas success.

Global Oil & Gas Capex, 2007A-15E (US$bn)



SOURCE: *GlobalData, various.*

Brent Crude Price, with EIA Predicted Averages



SOURCE: *FactSet, EIA.*

Mining

Ongoing commodity price volatility, coupled with rising costs across the board, is crippling the mining sector at present. Current trends are seeing miners increasingly pushed towards more remote and expensive areas, in pursuit of high-grade deposits; and raising capital for new ventures is proving a major challenge. Slowing growth in Chinese demand has added to bearish projections for the mining industry, with many miners pinning their hopes on continued market expansion in the Far East. The scale of the slowdown is shown by the potential of a A$246bn pipeline of planned investments in Australia falling through, with around half already frozen or likely to be delayed.

The expectation is that the top mining companies will see profits, return on capital and free cash flow fall during 2013; and due to these financial headwinds, capex should decline in parallel. Capital spending by the major mining companies is projected to reduce by over a fifth in 2013 compared with 2012, with developments in new markets providing most of the investment impetus.

Southern Africa is one region with a potentially positive outlook; and Mozambique, where Kentz is now the largest contractor, is being highlighted as a future mining hub. Mozambique has been marred by civil war for two decades, and having emerged from the conflict, the newly-stable nation is now attracting attention from majors such as Vale and Rio Tinto. Mozambique's coal deposits are ranked the fourth-largest in the world, and some estimates suggest the country could be producing 25% of the world's coking coal by 2025. In 2010, the mining sector contributed 6% to Mozambique's national GDP; and according to the IMF, major mining projects could contribute 18% to the total value added in the economy by 2016.

Petrochemicals

The main driver of petrochemicals market growth is expected to be rising demand in the Far East overshooting current capacity. Demand for polyolefins (plastics including polyethylene, which account for nearly half of Western Europe's plastic consumption each year) grew by 15-20% in Indonesia and Vietnam in 2012, with the rest of South-East Asia also exhibiting strong market growth. The rapid increase in demand for plastics from South-East Asian economies stems from burgeoning consumer spending, propelled by the wealth effect of booming property markets, with property prices in locations such as Indonesia quadrupling in US dollar terms over the last five years.

Far Eastern petrochemical capacity growth is expected to be echoed in the Middle East, albeit to a lesser extent. Petrochemicals production in the Persian Gulf states increased by 5.5% in 2012, and the proportion of global ethylene (the polyethylene building block) supply hailing from the Middle East now sits at just under 20%, where it is expected to remain over the next few years. Ethylene capacity in the Gulf states has doubled over the last five years; and Saudi Arabia accounts for over half of the regional total, with a capacity of 86.4Mt, up 7% over the course of 2012.

North America is expected to re-establish itself as an ethylene production hotspot, with more capacity expected to come online over the next decade than in the Middle East, although less than in China. The US petrochemical industry has benefited greatly from shale gas development, as natural gas feedstock is now so cheap that North America is now one of the lowest-cost producing regions globally.

The EU petrochemicals industry, by contrast, remains depressed, in the face of the continuing economic downturn. After contracting in 2012, to an estimated 8% below its pre-recession peak, EU petrochemicals output is projected to rise only around 0.5% in 2013.

Key Differentiators

Deep Roots in Construction

Kentz began as a construction business in South Tipperary, Ireland in 1919, and this segment remains the company's core area of expertise to this day. Much of a project's risk to the client is concentrated in the construction phase; and many operators, having won a construction contract, do not have adequate in-house capability to be self-sufficient in terms of execution, and are thus forced to outsource. Doing so adds layers of risk, with all parties having to co-operate to meet tight deadlines; and a weak link in the chain may lead to costly delays. Thus, Kentz's capacity to autonomously meet all the demands of the contract is an extremely desirable attribute in a service company.

One of Kentz's principal selling points is that the in-house construction team is equipped to deal with the most challenging environments. The company's Arctic division was formed in 2003, with the opening of an office on Sakhalin Island, in far eastern Russia, where an estimated 45bn boe lie offshore. Sakhalin's climate is severe, with winter temperatures falling as low as -40°C, autumnal blizzards proving common, and snowfalls continuing into June.

Oil Rig Near Sakhalin Island

SOURCE: *www.guardian.co.uk.*

Having established a base on the island, Kentz has been employed to work on sister developments Sakhalin-1 and Sakhalin-2, involving key clients ExxonMobil and Shell, respectively. Sakhalin-1 (in which Exxon has a 30% stake, and Rosneft affiliates 20%) comprises three fields, which are together estimated to hold 2.3bn bbl of crude oil and 17tcf of natural gas. Multiple industry records for depth and rate of drilling have been set at this project, and the world's longest well, the 12,400m deep 44-Chavyo, was drilled at Sakhalin-1 in August 2012. Kentz currently has two contracts on this project, involving construction, commissioning and ongoing project management.

The two fields of Sakhalin-2 (50% owned by Gazprom, 27.5% by Shell) contain an estimated 1.2bn bbl of crude oil and 18tcf of natural gas, and development is expected to ultimately cost upwards of US$20bn. Kentz has one contract on this project, involving multi-discipline construction, completion and commissioning work on the Lunskoye oil production facility and infrastructure buildings.

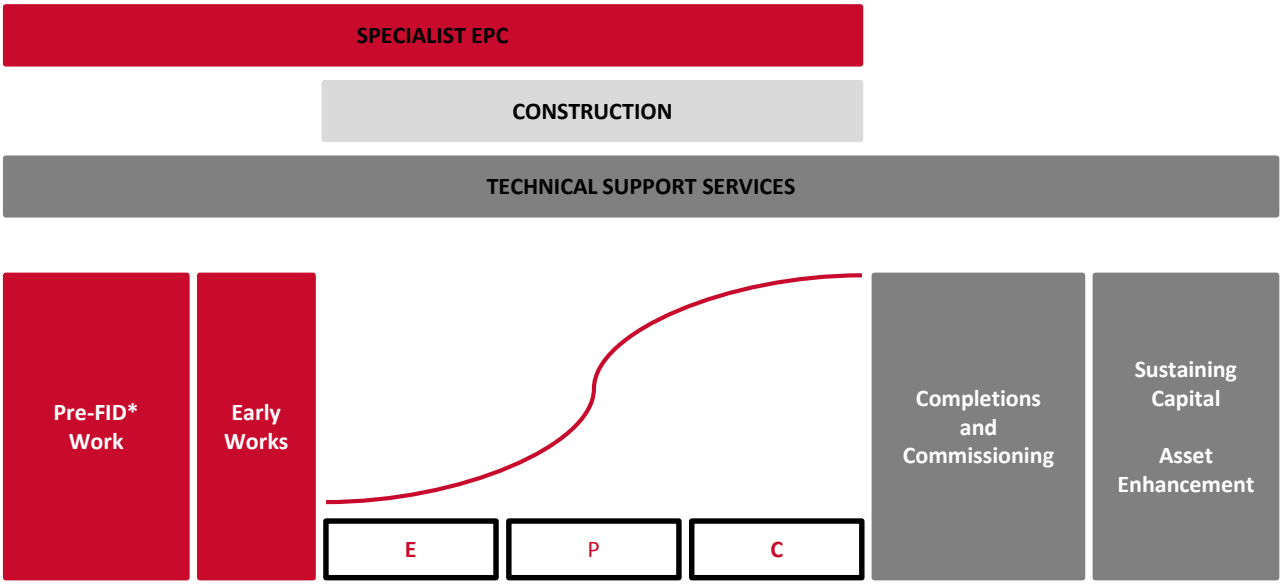
Kentz has been able to transfer this cold-climate operational expertise to the Kearl Oil Sands utilities project in northern Canada, where winter temperatures can also drop to tens of degrees below freezing. The Kearl Oil Sands contract, for ExxonMobil subsidiary Imperial Oil, involves electrical and instrumentation site works and bulk materials procurement for the utilities plant on Phase 1 of the project. Kentz's focus on challenging regions of northern North America is clearly paying dividends in terms of contract awards, with two secured in the Canadian oil sands and one in Alaska in H1 2013.

Awake to Opportunities Across the Value Chain

Kentz has the capacity to develop a project from day one to the completion then commissioning stages. Subsequently, it is then able to perform maintenance and install upgrades, meaning involvement with a particular project can be effectively ongoing. Kentz considers itself able to capture every part of the value chain, which confers the major advantage that it can take a multipronged approach to winning contracts on each project. All three business units can be involved in bidding for separate awards on a certain project, which de-risks the process to an extent.

Less diversified operators are far more likely to miss out on opportunities if they only have one point of entry to a project; whereas if Kentz does not win an EPC or Construction contract, there will still be the chance to secure completion or commissioning work.

Value Chain Flexibility



SOURCE: *Kentz.*

A pertinent example of Kentz's multifaceted approach to each new opportunity comes in the form of the Gorgon Project, in Western Australia. The project (47% owned by Chevron, 25% by ExxonMobil, 25% by RD Shell, and 3% by Japanese interests) will access gas from the Gorgon and Jansz-lo fields, located between 130km and 220km offshore, at 200-1,300m water depths. The Gorgon and Jansz-lo fields are together thought to contain as much as 35.3tcf of natural gas, and may have a lifespan of 60 years.

The Gorgon Project is the largest single resource development to have ever been initiated in Australia, and is expected to cost A$52bn. The project entails the construction of a three-train, 15.6Mtpa LNG plant on Barrow Island; and the installation of a domestic gas plant with the capacity to supply 300 terajoules of gas per day to Western Australia. Gorgon LNG will be offloaded via a 2.1km long loading jetty for transport to international markets. Domestic gas will flow to the Western Australian mainland along a 90km pipeline from Barrow Island.

Long-term LNG sales agreements have been reached between the Gorgon JV partners and customers in China, India, Japan and South Korea, with durations of 15-25 years.

Gorgon Construction Village

SOURCE: *www.kentz.com*

Gorgon Construction Project, Barrow Island

SOURCE: *www.laingorourke.com*

In June 2009, Kentz, in conjunction with two Australian partners, was awarded an A$500m EPC contract to design, prefabricate and construct a construction village on Barrow Island (pictured above left). The purpose of the village is to house 4,000 workers building the Gorgon Project's three LNG trains. Two months later, Kentz won its second contract on the Gorgon Project, an A$150m turnkey telecommunications package. The remit of the contract covers the design, supply, installation, testing and commissioning of the telecommunications on Barrow Island.

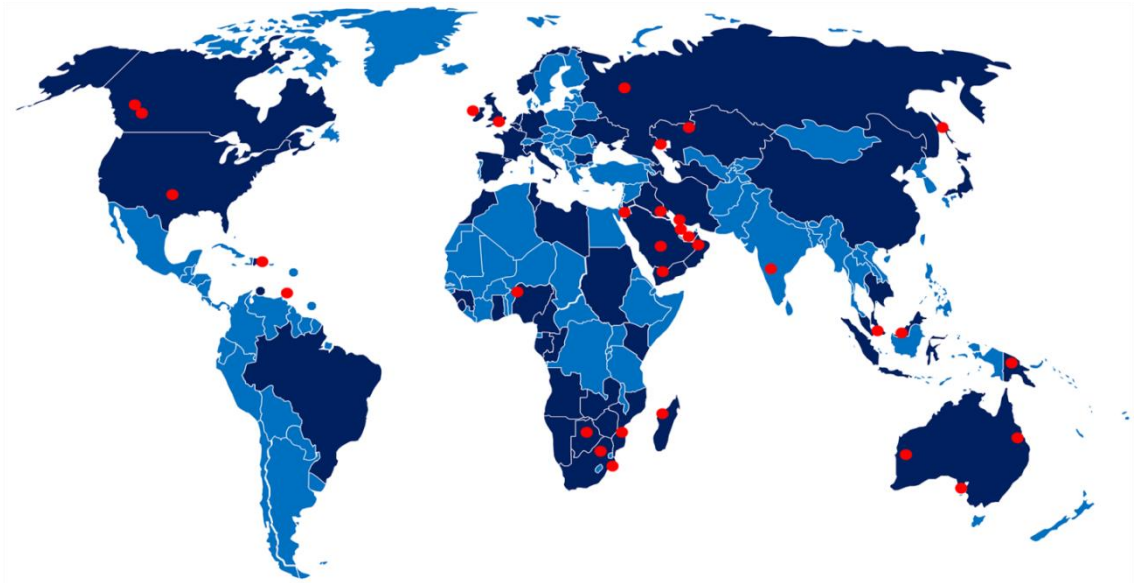
Finally, in July 2011, Kentz secured by far its most significant award on the Gorgon Project, a US$2.3bn construction contract in a JV with CB&I. Kentz has a 35% share in the JV, making its share of the contract worth US$810m, surpassing any previous contract win. The scope includes the structural, mechanical, piping, electrical, instrumentation and commissioning support for the construction of the Gorgon development's three 15.6Mtpa LNG trains. Extension of this service package to the associated utilities and domestic gas processing and compression plant also falls under the contract umbrella.

This project is a clear example of how a multi-pronged approach can pay off. Being already established at Gorgon, Kentz was in prime position to continue winning work, culminating in the award of its highest-value contract to date.

Decentralised Management Makes a Global Business Local

Kentz has decentralised management in each location, with decision-making capabilities bounded by set lines and limits. These dispersed individuals are thus in constant dialogue with clients worldwide, providing updates and reassurance. Managerial capacity on location serves to prevent avoidable and costly delays, caused by decisions having to filter across the globe from one Head Office. A second benefit is that well-placed personnel in key markets will hear about contract opportunities at an early stage, thus giving Kentz a head start in the bidding process.

Project Management and Regional Engineering Centres



SOURCE: *Kentz.*

Multi-Sector Spread Reduces Risk

Kentz is not confined to operating within any one branch of the natural resources sector, and thus has the flexibility to follow spending patterns, focussing on whichever industry is most buoyant at a given time. Oil and gas has traditionally dominated Kentz's project portfolio, although the company's service offering can equally meet the demands of the mining, power and petrochemical industries, among others.

Kentz's entry into the southern African mining space provides a good example of what the company terms "end market flexibility". In 2009, Kentz's activities in the mining and metals industry represented only 2% of company

revenue. However, having observed a slowdown in oil and gas capex within the southern African markets, Kentz was forced to seek opportunities in other industries. By 2011, the mining industry's contribution to Kentz revenues had grown to 24.3%, on the back of two significant contracts for Brazilian company Vale, and Montréal-based SNC-Lavalin.

The US$30m SNC-Lavalin contract, awarded in August 2010, was for service provision to the Ambatovy long-life nickel-laterite project; which is positioned to become the world's largest by 2014, with an annual design capacity of 60,000t. Kentz was contracted to carry out the electrical and instrumentation installation for the entire metals refinery area, and the piping fabrication and mechanical installation for part of this area.

The US$69m Vale contract, for the Moatize Coal Project in Mozambique, was awarded in January 2010. Moatize is located in Tete Province, 1,700km north of Mozambique's capital Maputo, and is Vale's first greenfield project in Africa. Kentz's remit was to perform structural, mechanical, electrical, instrumentation and piping installation for the coal processing plant, which will ultimately have the capacity to handle 26Mt of coal per annum.

Moatize Phase 1 is now finished, and has a capacity of 11Mtpa of coal, roughly divided into 70% coking coal and 30% thermal coal. The Phase 2 expansion should double these figures. To date 27% of the expansion project's physical infrastructure has been completed.

Following on from the Moatize award, Vale (in association with the Mozambique Port and Railways Authority) awarded Kentz a US$38m contract for the related Nacala Corridor Project in July 2013. The Nacala Corridor Project, scheduled for completion in November 2014, is intended to enable the transportation of coal mined in inland Moatize to the maritime terminal located in Nacala, on the Indian Ocean, via a new 912km railway corridor. Kentz has been contracted to undertake the structural, mechanical, electrical and instrumentation installation, and provide commissioning assistance required to construct the main stockyard equipment. When complete, the rail link will have the capacity to transport 18Mtpa of coal.

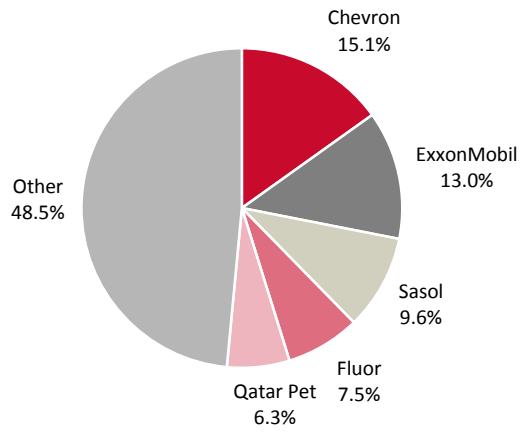
The contract awards for Vale have positioned Kentz as the foremost contractor in Mozambique, although the percentage of overall revenues from mining did fall in 2012, as growth oscillated towards the petrochemical space.

Top Clients

Kentz's top clients by revenue are, in descending order: Chevron (four projects, 15.1%), ExxonMobil (eight projects, 13.0%), Sasol (three projects, 9.6%), Fluor (five projects, 7.5%) and Qatar Petroleum (two projects, 6.3%).

The vast majority of the time, when Kentz enters a new geographic area, it is following an existing client. This year, for example, the company has moved into Colombia, to complete the US$58m Reficar Refinery Expansion project for CB&I. Once established in a new area, Kentz hopes to build up a presence, and continue to win work for established or new customers.

Proportion of Revenues from Top-Five Clients



SOURCE: *Kentz, VSA Capital.*

Chevron

While Chevron topped the list of clients by revenue in 2012, this is mainly due to the company's 47.3% interest in the Australian Gorgon Project, worth US$810m to Kentz. Chevron has also awarded Kentz work in Kazakhstan, one of the countries marked out for significant upstream investment in 2013. Eighty percent of California-headquartered Chevron's US$33bn upstream budget will be spent internationally, on projects in Kazakhstan, Angola, the DRC, Russia and China; and on deepwater ventures in Nigeria and Brazil. Through this capex initiative, a diverse range of opportunities should be presented to well-positioned service companies worldwide.

ExxonMobil

ExxonMobil is the world's largest company by earnings (H1 2013 profit was US$9.5bn); and has been a crucial client of Kentz's, providing work annually with a global spread. ExxonMobil has consistently been the hydrocarbon industry's biggest spender, dependably topping charts for the last three decades. The company is planning an aggressive capex programme, which will see US$38bn invested annually between 2013 and 2017; and management hope a cash injection of this magnitude will boost output by 2-3% annually.

Sasol

Since establishing a presence in South Africa in the 1980s, Kentz has maintained its position as one of the country's largest construction companies, establishing a strong relationship with Johannesburg-headquartered energy and chemical company, Sasol. The company is currently focussing beyond its borders, planning to invest up to US$21bn in one fuel and one petrochemical plant in Louisiana, to take advantage of cheap US shale gas. The final decision on the projects, which will cost the equivalent of two-thirds of Sasol's market cap, will be taken in 2014.

Sasol, which is currently the world's top producer of vehicle fuel from coal, will continue investing in domestic ventures, as it attempts to reposition itself as a lower carbon emitter. Petrochemicals, gas and clean energy are three fields in which it has been expanding investment; and Kentz's non-sector specific approach should position it well for further contract awards, should Sasol continue to diversify its activities.

Fluor

Kentz's first international contract award was from Fluor, in Saudi Arabia, in 1977. The two companies have retained a close relationship over the intervening decades, with Fluor consistently positioned as one of Kentz's top clients. Texas-headquartered Fluor works in a wide range of sectors, including oil and gas, petrochemicals, mining, power, telecommunications, and infrastructure. Thus, Fluor's diverse project range and Kentz's multi-industry service capabilities are a good fit.

Fluor saw a decline in its backlog in late 2012, after losing two major mining projects worth US$2bn, while its 2013 outlook fell short of expectations. The backlog at the end of Q1 2013 was US$37.5bn, down 12% from a year earlier, due to suppressed investment in the mining and metals markets. Around 80% of this backlog is, however, outside of the US, providing something of a safety net in terms of wide-ranging market exposure.

Qatar Petroleum

Qatar Petroleum is state-owned, and has a monopoly on all oil and gas industry operations in the country. In 2011, Qatar announced plans to invest an average of US$25bn per annum on construction and hydrocarbon-related projects, with the government relying heavily on revenues from oil and gas exports. In 2012, oil and gas exports accounted for 50% of Qatar's GDP and 70% of government revenues.

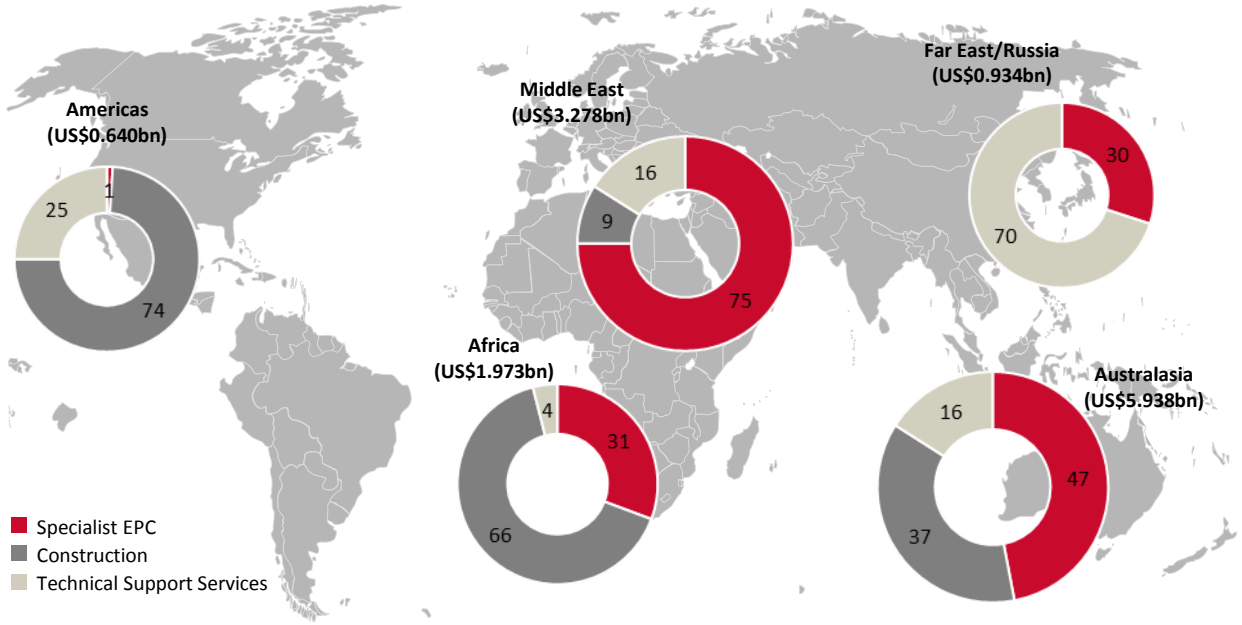
In recent months, Qatar Petroleum has also been active in making overseas acquisitions. In April 2013 it was announced that together with Centrica, Qatar Petroleum had acquired Canadian natural gas and crude oil assets from Suncor Energy in a C$1bn deal. Subsequently, in May 2013, it was revealed that Qatar Petroleum had agreed to purchase a stake in Total's Congo operations, representing the company's first investment in an overseas offshore field. The international expansion of Qatar Petroleum's operations should provide opportunities for service companies in the new jurisdictions entered.

Geographic Reach

Kentz's backlog (which reflects the value of future workload on Kentz's books, comprising contracts in progress, contracts yet to be completed, and confirmed new orders) is also weighted heavily towards Australia. As of end-2012, contracts in Australia accounted for 59% of the backlog, Africa 16%, the Middle East 14%, the Americas 8%, and the Far East 3%.

Kentz estimates the total value of global resources projects at US$4.5trn, of which roughly US$845bn worth will be outsourced to service providers. Contracts with a market value of US$503bn are deemed potentially addressable by Kentz, and this figure is distilled down to a pipeline of US$14bn. Of this, Kentz would hope to win 20-25% of contracts. The global distribution of Kentz's contract opportunities is shown below.

Kentz Pipeline Overview by Region



SOURCE: *Kentz.*

Africa

Kentz estimates a global total of US$49.5bn of upstream, midstream and downstream contracts, and US$27bn of mining contracts will be awarded to service providers in Africa between 2013 and 2015. The company currently has a workforce of around 3,000 located in southern Africa, and is active in South Africa, Botswana, Mozambique and Madagascar.

Kentz anticipates that upstream onshore opportunities will begin emerging in East Africa; while there is also major growth potential in the LNG space in Mozambique and Tanzania, following recent large-scale natural gas discoveries. Mozambique is thought to hold 4.4tcf of gas reserves, the exploitation of which would surely provide ample work for Kentz, provided it retains its prime position in the country. The company is hoping that LNG contracts will begin filtering through within the next two years, though expects that it will be 16-18 months before anything tangible occurs regarding LNG development in Mozambique.

Kentz is also looking to open an office in Ghana within the next six to twelve months, from which to target projects in nearby Guinea as well as Ghana itself. While it accepts that business growth in West Africa may be slow, the company is keen to build a base, and considers offshore Ghana as a key upstream development area.

Middle East

Kentz estimates a global total of US$174bn of upstream, midstream and downstream contracts, and US$9bn of mining contracts will be awarded to contractors in the Middle East between 2013 and 2015. Kentz anticipates that 60% of upstream awards will come from Iraq and Saudi Arabia over the next two years. Qatar is the dominant midstream player; while Saudi Arabia, Kuwait and the UAE should be the major spenders on petrochemicals developments. Kentz's Middle Eastern capacity spans Saudi Arabia, Qatar, Kuwait, the UAE and Iraq. Competition in the Middle East has been stiff recently, though a revival in bidding activity seems to be occurring at present.

One of the emerging issues with securing contracts in the Middle East has been the rise of Korean contractors, who are prepared to undercut all other bidders, regardless of margins. Korean contractors are primarily keen to bring US dollars into the Korean market, and are thus more concerned with cash flow than the size of the profit they will ultimately make. However, there have been issues with certain contractors aiming to operate so cheaply that they are unable to finish projects. Potential openings are then presented to companies such as Kentz to complete the work.

Australia

Kentz estimates a global total of US$69bn of upstream, midstream and downstream contracts, and US$50bn of mining contracts will be awarded to service providers in Australia between 2013 and 2015. Kentz expects much of the predicted US$13bn upstream spending in Australia over the next two years will go towards LNG-related projects, and the company intends to focus on this space. Kentz still has two years' work on the Gorgon Project, and is now turning its attention to the next big LNG opportunity in Australia, namely the Ichthys Project.

The Ichthys Field is located in the Browse Basin, offshore Western Australia, and most likely resource estimates currently stand at 12.8tcf of gas and 527mmbbl of high-value condensate. The construction phase is now under way, following the final investment decision in January 2012. The Ichthys Project will have an initial capacity to produce 8.4Mt of LNG per annum and 1.6Mt of liquefied petroleum gas (LPG) per annum, as well as approximately 100,000bbl of condensate per day at peak.

Although the Ichthys Project is clearly at an early stage, Kentz anticipates that the ultimate spend will rise to around US$40bn, and is confident of winning a decent quantity of work. The company is current bidding on between US1bn and US$2bn of contracts to be awarded later this year and, if successful in future bidding rounds on Ichthys, the project could provide revenue for the next four to five years.

As far as the Australian mining industry is concerned, Kentz is still open to opportunities, but is not optimistic in the near term. This beleaguered industry must recover before the company can build up its mining pipeline in the country.

Two encouraging signs for the Australian resources sector as a whole are the planned abolition of carbon tax, and falling costs. The carbon tax, which was introduced in July 2012, forces firms to pay a levy for every tonne of greenhouse gases they emit. The scheme has thus far proved ineffective in reducing CO_2 output, and the planned replacement emissions trading scheme should see the cost of carbon emissions fall from A$25.4/t to A$6/t. This would obviously enable significant savings in natural resources contracts across the board, stimulating the sector and encouraging new projects. Falling costs, meanwhile, should be positive for contract margins.

North America

Kentz estimates a global total of US$112.5bn of upstream, midstream and downstream contracts, and US$44bn of mining contracts will be awarded to contractors in North America between 2013 and 2015. Kentz is a relatively new player in the North American field. However, it has experienced massive growth in its Canadian arm since it first entered the country in 2008. Imperial Oil has become a key client in the Canadian oil sands space, and working in the north of North America has allowed Kentz to leverage the Arctic expertise it developed at Sakhalin. Kentz has won around US$300m of Canadian contracts in the last few months. It also clinched a commissioning contract in Alaska in June 2013, the company's largest US contract to date.

Over the next two years, Kentz expects US$8bn of Canadian midstream spending to be concentrated on four new LNG plants based on shale gas. The company also expects US$7bn to be spent on the possible development of between four and ten LNG plants in the US over the same period. These LNG projects could represent a chance for Kentz to transfer its LNG expertise, developed in Australia, over to North America.

Russia and the Far East

Kentz estimates a global total of US$99bn of upstream, midstream and downstream contracts, and US$25bn of mining contracts will be awarded to contractors in the Russia and the Far East between 2013 and 2015. The company anticpates that significant Russian oil and gas industry spending will continue being put towards developing the Sakhalin area.

Kentz has been working with ExxonMobil on the Sakhalin-1 project since 2005, and is now looking to follow this key client into mainland Russia. ExxonMobil is involved with Rosneft in looking at oil prospects around the Black Sea, and Kentz is waiting for this preliminary activity to develop into future contracts. Kentz has identified opportunities in Russia with ExxonMobil, involving all three business units (EPC, Construction and TSS), which can be bid on over the next couple of years.

Financials

Profit and Loss

Year End December (US$m)	2011A	2012A	2013E	2014E	2015E
Total revenue	**1,368**	**1,413**	**1,524**	**1,648**	**1,806**
Cost of sales	(1,207)	(1,228)	(1,338)	(1,447)	(1,586)
Gross profit	**161**	**185**	**186**	**201**	**220**
Gross profit margin	*11.8%*	*13.1%*	*12.2%*	*12.2%*	*12.2%*
SG&A expenses	(96)	(108)	(114)	(124)	(135)
Other operating income/expense	1.3	1.5	1.5	1.5	1.5
EBIT	**66**	**78**	**73**	**79**	**86**
EBITDA (including Kentz' share of JV profits)	**98**	**119**	**124**	**134**	**141**
Operating profit margin	*4.8%*	*5.5%*	*4.8%*	*4.8%*	*4.8%*
Net finance income	(0.7)	0.2	0	0	0
Share of JVs profit/ loss	14	27	41	45	45
Profit before tax	**79**	**105**	**114**	**124**	**131**
Clean PBT margin	*5.8%*	*7.4%*	*7.5%*	*7.5%*	*7.3%*
Tax rate	23%	24%	27%	26%	26%
Tax expense	(18)	(26)	(31)	(32)	(34)
Profit after tax	**61**	**79**	**83**	**92**	**98**
Net profit margin (rpt)	*4.5%*	*5.6%*	*5.5%*	*5.6%*	*5.4%*
Profit attributable to (rpt):					
Kentz shareholders	59	70	80	89	95
Non-controlling interests	2	9	3	3	3
Basic wtd ave shs (m)	116	116	118	118	118
Basic EPS (US$ cents)	**50.6**	**60.0**	**68.1**	**75.5**	**80.2**
Est dilutive shares	4	4	4	4	4
Wtd Av Dil Shs (m)	120	120	122	122	122
Diluted EPS (US$ cents)	**49.0**	**58.0**	**65.9**	**73.0**	**77.6**
Dividend per share (US$ cents)	**12.3**	**14.5**	**16.5**	**18.2**	**19.4**

***SOURCE**: Company data, VSA Capital estimates.*

Balance Sheet

Year End December (US$m)	2011A	2012A	2013E	2014E	2015E
Assets					
Cash & equivalents	226	238	223	269	269
Overdraft	0	0	0	0	5
Trade and other receivables	287	260	260	260	260
Amounts due from related parties	4	4	4	4	4
Work in progress	127	135	125	125	125
Total current assets	**656**	**623**	**658**	**695**	**740**
Gross PPE	77	60	52	47	42
Depreciation	17	13	10	10	10
Net PPE	60	47	42	37	32
Goodwill	4	4	4	4	4
Other investments	4	15	15	15	15
Trade and other receivables	1	13	13	13	13
Deferred tax assets	4	5	5	5	5
Intangibles	0.9	0	0	0	0
Total long-term assets	**74**	**84**	**79**	**74**	**69**
Total assets	**730**	**706**	**737**	**769**	**809**
Liabilities + equity					
Trade and other payables	431	348	348	348	348
Corporation tax payable	17	20	21	23	25
Interest bearing loans and borrowings	-0.48	-0.03	0	0	0
Obligations under finance leases - due within 1 year	5	5	5	5	5
Amounts owed to related parties	13	27	15	15	15
Total current liabilities	**467**	**399**	**389**	**391**	**393**
Interest bearing loans and borrowings	0.06	0.02	0	0	0
Obligations under finance leases - due after 1 year	7	2	2	2	2
Employee benefit obligations	9	18	10	10	10
Amounts owed to related parties	0.1	0.1	0.1	0.1	0.1
Trade and other payables	5	6	5	5	5
Deferred tax liabilities	3.4	0.8	0	0	0
Total long-term liabilities	**25**	**27**	**17**	**17**	**17**
Total liabilities	**492**	**426**	**-406**	**408**	**410**
Share capital	2.3	2.3	2.3	2.3	2.3
Share premium	40	44	44	44	44
Treasury shares/ reserve	(0.7)	(4.2)	(4.2)	(4.2)	(4.2)
Reserves	8	9	9	9	9
Retained earnings	178	227	278	308	346
Non-controlling interests	11	2	2	2	2
Total equity	**238**	**280**	**331**	**361**	**399**

***SOURCE**: Company data, VSA Capital estimates.*

Cash Flow

Year End December (US$m)	2011A	2012A	2013E	2014E	2015E
Cash from operations					
PBT (rpt)	**79**	**105**	**114**	**124**	**131**
Depreciation	17	13	10	10	10
Amortisation of intangible assets	0.7	0.5	0	0	0
Net finance income/ expense	0.7	(0.2)	0	0	0
Gain/loss on sale of property, plant & equipment	0.7	(0.4)	0	0	0
Share of profit/loss from joint ventures	(14)	(27)	(41)	(45)	(45)
Impairment of PPE	1.5	0	0	0	0
Current service cost	0	0	0	0	0
Share based payments	2.9	3.5	3.5	3.5	3.5
Increase/decrease in trade and other receivables	(63)	13	-	-	-
Increase/decrease in work in progress	(46)	-8	10	0	0
Increase/decrease in trade and other payables	72	(65)	-	-	-
Cash from operations	**53**	**35**	**97**	**92**	**100**
Interest paid	(2.2)	(0.9)	(1)	(1)	(1)
Income tax paid	(19)	(27)	(29)	(32)	(35)
Net cash from operations	**32**	**6**	**66**	**60**	**64**
Cash from investments					
Investment in/return from joint venture	18	16	10	10	10
Disposal of subsidiary (net of cash)	(5)	(2)	0	0	0
Purchase of property, plant and equipment	(13)	(4)	(5)	(5)	(5)
Proceeds from sale of equipment	0.7	2.5	0	0	0
Interest received	1.8	1.8	2	2	2
Pension contribution	(3)	0	(3)	(3)	(3)
Net cash from investments	**(0.2)**	**13**	**4**	**4**	**4**
Cash from financing					
Proceeds of share issue	0	4	0	0	0
Expenses associated with new share issue	0	0	0	0	0
Proceeds from finance lease liabilities	0	0	0	0	0
Payments of finance lease liabilities	(5)	(5)	(5)	(5)	(5)
Proceeds from long-term borrowings	0.08	0	0	0	0
Payments of long-term borrowings	(0.05)	-0.08)	0	0	0
Payments of short-term borrowings	(1.4)	0	0	0	0
Proceeds from short-term borrowings	0	0	0	0	0
Dividends paid to equity holders of the Company	(14)	(15)	(19)	(22)	(23)
Net cash from financing	**(21)**	**(38)**	**(24)**	**(27)**	**(28)**
Change in Cash	11	(18)	46	37	40
Cash and cash equivalents at the beginning of the year	**226**	**238**	**223**	**269**	**306**
FX Adjustments	1	4	0	0	0
Cash and cash equivalents at the end of the year	**238**	**223**	**269**	**306**	**346**

***SOURCE**: Company data, VSA Capital estimates.*

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BUY: The stock is expected to increase by in excess of 10% in absolute terms over the next twelve months.
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SELL: The stock is expected to decrease by in excess of 10% in absolute terms over the next twelve months.

In addition, on occasion, if the stock has the potential to increase by in excess of 10%, but on qualitative grounds rather than quantitative, a Speculative BUY may be used.

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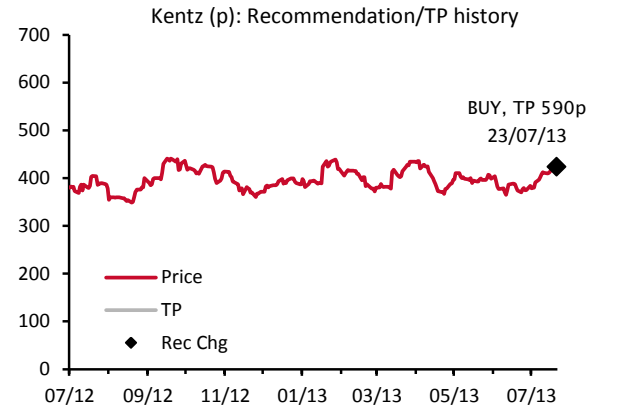
Equities breakdown: 30 June 2013	Spec. BUY	BUY	HOLD	SELL
Overall equities coverage	15.6%	71.9%	6.3%	6.3%
Companies to which VSA has supplied investment banking services	15.4%	84.6%	0.0%	0.0%

Recommendation and Target Price History



***SOURCE**: FactSet data, VSA Capital estimates.*

Valuation basis

We have elected to blend the results of our DCF model (10% WACC, 3% TGR) and peer group analysis, to obtain our target price.

Risks to that valuation

Failure to win contracts; increased proportion of reimbursable contracts pushing down margins; large, revenue-generative Gorgon Project not being followed up by awards of a similar scale.

This recommendation was first published on 23 July 2013.