OIL & GAS INDUSTRY

OVERVIEW

For the purposes of analyzing rates in the oil and gas industry, ECRL divides the rats into two groups: oil and gas companies and oilfield service companies. The oil and gas companies are further subdivided into three groups: the independent exploration and production (E&P) companies, independent refiners/marketers and the integrated oil and gas companies. Engaged primarily in the exploration, development and sale of crude oil and natural gas reserves, independent E&P companies are most susceptible to commodity price swings of the three groups, and exhibit significant earnings and cashflow volatility. The hunt for new reserves at competitive prices is a major ongoing challenge for E&P players given the upward pressure on the cost of acquiring, finding, and developing acreage and reserves. ECRL remains ever mindful of the event/execution risk that is associated with investments and acquisitions to replace reserves and its potential consequences on the company's financial and business risk profile.

Independent refiners and marketers manufacture and sell refined products, purchasing their feedstocks from producers on the open market. Refining margins are sensitive to available refining capacity which is a function of the demand for refined products, and price movements on crude inventories. The profitability of the refinery operations will also be driven by scale economies and ability to convert feedstock to high value products. Of the three groups, the integrateds have the strongest credit profile by virtue of their breadth of operations (upstream and downstream), geographic diversification and higher earnings stability. In a high oil price environment, margins for refined products decline as the cost of crude oil and other feedstocks increase more rapidly than the prices of gasoline and other products, such as asphalt, fuel oils, petroleum coke, and petrochemical feedstocks. The higher E&P earnings will help dampen the effect of the weaker refining margins, thus helping stabilise cash flow.

The link between oil and gas companies, in particular the E&P companies and integrateds, with the oilfield service companies gives rise a significant number of shared industry and business risk drivers. Oilfield service companies provide a myriad of support services to the oil and gas sector which include contract drilling, platform construction, operating numerous types of offshore drilling rigs, seismic acquisition and analysis, and other specialty services including marine engineering and transportation. The business outlook for oilfield service companies is significantly affected by the level of energy industry spending for the exploration and production ("E&P") of oil and natural gas reserves. A key indicator for this spending is the rig count because when drilling and workover rigs are active, many of the products and services provided by the oilfield services industry are required. E&P spending by oil and gas companies is, in turn, influenced strongly by expectations about the supply and demand for oil and gas products and by current and expected prices for both oil and gas which are, in turn, sensitive to a host of factors including:

- the balance between supply and demand as indicated by inventory levels,
- supply disruptions,
- global economic growth,

- the degree to which individual OPEC nations and other large oil and natural gas producing countries are willing and able to control production and exports of oil,
- technological advancements that improve total recovery and productivity,
- access to prospects or untapped reserves,
- ability of oil and natural gas companies to access the funds necessary to carry out their E&P plans, and
- government regulations, including environmental regulations, which affect production cost and may limit the quantity of oil and natural gas that may be economically produced.

The finite supply of global oil resources and increasing finding and development costs are factors supporting long-term oil prices, while short-term oil prices are significantly influenced by changes in global economic growth and OPEC production. This was clearly seen with oil price movements in 2008 where in the first half of the year, prices and global oil consumption moved up together, and then down together in the second half, because of the shrinking global economy.

When oil prices are high, oilfield services investments benefit from an increase in the demand for the equipment (e.g., rigs) and systems needed to extract the resources rises, leading to higher day rates as well as greater utilization. When oil prices are low, the highly capital intensive oilfield service providers face the prospect of their infrastructure, specialized tools and machinery and facilities becoming idle if their E&P clients scale back operations.

ANALYTICAL FRAMEWORK

ECRL's rating approach to oilfield service providers follows a broad framework, the major areas of focus comprise:

- Business Risk
- Operations Risk
- Financial Risk
- Management and Qualitative Factors

BUSINESS RISK

ECRL considers the market position of the oilfield services provider in its core oilfield service markets and segments and the defensibility of its competitive position, geographic diversity, the intensity of competition as well as the barriers to entry for its primary business lines. The customer base of an oilfield services provider typically comprises the state–owned national oil company (or companies where its operations are geographically diversified) as well as multinational oil majors. ECRL regards the length of the ratee's relationships with its customers, its success in securing contract renewals from existing customers, the proportion of business secured through competitive bidding, order backlog and new order intake as important indicators of its competitive standing.

ECRL seeks to identify the ratee's competitive advantages as well as challenges or weaknesses in its chosen business lines. The ability of an oilfield services provider to compete in the oilfield services market is a function of their ability to differentiate its product and service offerings by technology, service and the price paid for the value delivered. Success in marketing geophysical services for the oil and gas industry, for instance, is based on several factors, including price, crew experience, equipment availability, and technological expertise, reputation for quality and dependability and safety record. Where project-oriented oilfield service providers such as EPCM companies are concerned, ECRL believes the following to be key determinants of competitiveness: a proven and historic track record of project completion and client satisfaction as well as the ability to complete projects on schedule while meeting customers' performance requirements and budgetary needs.

Market diversity helps to mitigate the impact of the cyclicality in the ratee's core markets. A continued strategy of maintaining a good balance across its entire business portfolio permits the oilfield services provider to focus on its more stable business markets while also remaining ready to capitalize on developing its cyclical markets when they are strong. Accordingly, this allows the ratee to better weather any downturns in a specific market.

ECRL looks at the trends in the oilfield services provider's backlog of commitments for future revenue, the expected time frame for the completion of written orders or firm commitments. Of relevance to ECRL's analysis is whether the contracts for services may be subject to modification by mutual consent or cancelable by the customer on short notice without penalty. ECRL recognizes that because of these factors, a ratee's backlog as of any particular date may not be indicative of its actual operating results for any succeeding period. The form of contracts, fixed price or cost-plus, and the lifetime of the contract are determinants of potential earnings variability and earnings visibility. An exceptionally large increase in the order backlog figure may signal an aggressive competitive stance that could constrict profit margins and limit the ratee's ability to pass on rising input costs on fixed price contracts.

ECRL also examines customer concentration, that is, the degree to which the ratee relies on order flow from individual customers or a single contract on hand, and the collectability of receivables from significant customers. We would consider any customer who accounts for 10% or more of the ratee's total revenue as significant.

A ratee which derives substantial portions of its revenue from foreign activities faces risks associated with their foreign revenue generating activities. Foreign revenue is subject to certain risks, including those related to foreign exchange movements, border disputes, war, terrorism, civil disturbances, embargo, and government activities such as radical changes in tax regulations or investment laws. In instances where the oilfield services provider generates significant revenue or has large local investments in a political and legal environment is less stable than its home country, its exposure could be material to its financial condition and results of operations. Finally, foreign operations result in accounts receivable or accounts payable that are denominated in foreign currencies and, are therefore, subject to fluctuations in foreign currency exchange rates.

Track Record - ECRL's analyst takes into consideration the rated entity's level of experience in the particular oil and gas business and the ability of the company to deliver its products/services within the stipulated time and budget. A company's strong track record serves as a barrier to entry to other prospective players. Although pricing is a major factor when awarding contracts, many oil majors prefer to work with oil and gas service providers that have proven track records and the ability to deliver on time. For example, the benefits of early commissioning of a new plant may actually outweigh the initial costs of the project.

Technical ability **-** In the oil and gas industry, engineering expertise and technical ability may differentiate a high-end product manufacturer from a lower-end manufacturer. However, companies that have tie-ups or collaboration with technically renowned oil and gas specialists in the international arena may be able to leverage on the reputation of the stronger partner when tendering for new contracts. As such, acquisitions of new technologies are also viewed favorably if they serve to improve the company's competitive position in the industry.

Supply Risk - For the acquisition of raw materials that are exposed to price volatility (eg steel), the establishment of back-to-back arrangements with the supplier and client is viewed favorably as it would enable the company to lock-in raw material prices at the start of the contract, or, in the event of price increases, pass this on to its clients.

Competitive Position - One way to look at this area is to identify the company's market share relative to its peers locally as well as internationally (if applicable). ECRL's analyst will want to know if the products/services are easily replicated and also gauge the competitive strength of other similar players in the industry.

OPERATION RISK

Operations & Maintenance - Apart from the normal plant maintenance and shutdowns, ECRL's analyst will enquire whether there were any unexpected interruptions to the operations of the plant and how the problem was addressed. Other considerations include determining the capacity utilization of the plant against its historical performance. For a marine engineering company, other factors that may be considered are the costs of dry-docking and number of dry-docking days.

Insurance - This area addresses whether the company is sufficiently insured to mitigate risks associated with business interruptions and operation. Apart from the usual insurance policies, the analyst should also identify whether there exists other insurance policies which are unique to the business of the issuer.

Government Regulation/Licensing - Incentives from the government may include reinvestment allowances and exemption on taxes (corporate, import, export) which may be applicable in either the local or export countries.

The success of oilfield service providers depends upon attracting and retaining highly skilled professionals and technical personnel. Failure to continue to attract and retain such individuals could adversely affect the ability of the oilfield service provider to compete in its particular segment. The company may confront significant and potentially adverse competition for key personnel, particularly during periods of increased demand for oilfield services.

FINANCIAL RISK

Financial strength varies according to market share, geographical scope of operations, breadth of products and services, technological capabilities, acquisition trails and financial policy. When analyzing financial risk,

ECRL's analyst takes into consideration the following:

Profitability/Earnings

A sharp drop in oil and gas prices results in rapid and substantial reductions in exploration and production expenditure. Exploration offshore will also be somewhat curtailed but commitments already planned are likely to be carried through. ECRL considers the ratee's performance over a longer term, the impact of cyclical highs and lows on its earnings and margins, and its resilience in past down cycles as well as ability to adjust its operating cost base in response to a weak revenue environment. The evaluation of the company's profitability and earnings analysis can be determined through the historical and current operating profit margins as well as its growth pattern. Besides the pace of growth, analysts also tend to assess performance by evaluating profits to assets, permanent capital and to equity, and the interest coverage ratio. Analysis of profitability measures becomes more meaningful when compared against peers in the industry. The general financial indicators include:

- Revenue (RM mil)
- Profit before tax (RM mil)
- Profit after tax (RM mil)
- OPBIT margin (%)
- OPBIT interest coverage (x)

Capital structure/Financial flexibility
Evaluation of the company's capital structure and financial policies is an indication of its risk orientation. The extent to which it decides to finance its operations with debt rather than equity will influence the analyst's rating recommendation, upon benchmarking. The general financial ratios used include:

- Debt to Equity (x)
- Long-term Debt to Equity (x)
- Short-term Debt to Equity (x)
- Total liabilities to total assets (x)

Cash flow protection
Detailed financial sensitivity analyses are carried out to assess the robustness of the cash flow projections under various adverse scenarios including vulnerability to increase in raw material costs, lower sales and delay in collection of receivables, amongst others. Even in periods of pricing erosion and weak revenue growth, the ratee often has to maintain its long-term commitments to technology development, key skill sets and service and product quality. The exposure of coverage measures to economic risk (adverse movements in interest rates, exchange rates and inflation rates) may also be evaluated. ECRL's analysis of cash flow protection includes some of the following:

- CFO gross int. Coverage (x)
- CFO debt coverage (x)
- CFO against capex (x)
- Debt Service Cover Ratio (DSCR) (x)
- Cash flow projections/Sensitivity Analysis (Robustness of debt service coverage measure under various sensitivity scenarios)

MANAGEMENT AND QUALITATIVE FACTORS

Whilst the quality of a company's management may be difficult to quantify, the assessment of management's abilities and risk appetite are important in assigning a rating. Some of the attributes that the analyst would consider include:

- Experience - track record and background

- Competence - ability to adjust and cope with changes in product dynamics, business climate, and industry and economic environment.
- Depth - good support in areas of planning, marketing, engineering, production, finance, control etc
- Style - conservative, aggressive or precarious
- Independence - professionals or owners
- Reputation and integrity
- Decision-making process
- Management policies, practices and control
- Business outlook and strategy
- Quality of middle management.