PEC Limited

Victor Portfolio Management

Wai Yeong Choun Victor

15 November 2012

Ticker	IX2
Exchange	Singapore Stock Exchange
Industry & Sector	Services, Oil & Gas
Market Capitalization	S$ 153,094,200
52-wk Price Range	S$ 0.555 – S$0.855
Recent Price	S$ 0.600 (15/11/2012)
Net Asset Value	S$ 0.860 (30/09/2012)
Current P/E	13.37x
Projected 2014 P/E	4.50x
Dividend Yield	4.17%
Benchmark	FTSE ST Oil & Gas
Listed Peers	Keppel Corp, Swiber, Ezra, Rotary, Moya Dayen

Recommendation

BUY

Pros

- Booming petrochemical and LNG industries in Singapore
- 50% market share on Jurong Island
- Reputable for workplace safety
- Strong order book of $353 million; order-bill ratio 0.99x
- Ready to pounce on opportunities with $0.45/share in cash

Cons

- Limited capability to take mega-projects
- Manpower and material costs pressure net profitability
- Failed Verwater-Audex Joint Venture drags bottomline

Intrinsic Value

S$ 0.745

Based on Residual Income Model
Upside potential: 24%

1. Business Summary

PEC Ltd is a plant and terminal engineering specialist with fabrication facilities spread across 3 regions- Asia, Middle East and Europe. The Group's core revenue streams are project works and contractual plant maintenance & services. Project works include engineering, procurement, construction (EPC), EPC project management and consultancy services. With a five-prong long-term strategy focus on widening its revenue base, PEC is expanding its operations horizontally and vertically. The strategy targets four main sectors: oil & gas, petrochemicals, oil & chemical terminals and pharmaceuticals. In 2011, it was listed by Forbes Asia's "Best Under A Billion" list, one of the 6 Singapore companies to achieve the recognition. Singapore remains the largest revenue contributor by country, declining to 57% from 71% a year ago.

2. Brief Industry Overview

Singapore is one of the top 3 petrochemical export refinery centers in the world and is Asia's oil hub leader. In addition, it is the world's busiest marine bunkering center despite being an oil-impoverished state. With lower benchmark Brent crude prices, economies of scale in oil refinery and strategic positioning of Singapore, demand for ex-wharf oil is increasingly preferred to fuel oil cargoes. Total bunker sale is 0.27% higher through September 2012 compared with a year ago. These are contributing factors to why major oil companies such as Exxon Mobil, Shell and BP look to establish important subsidiaries in Singapore.

Singapore's LNG industry is booming. The country is building 4 LNG tanks to procure its energy supply, with a fifth tank in consideration. With proper LNG infrastructure, Singapore not only has secured its energy source, but also able to encourage an "eco-system of LNG traders to Singapore", said Mr. S Iswaran, Second Minister for Home Affairs and Trade & Industry. Energy Market Authority (EMA) expects gas demand to grow 15 million tonnes per annum (tpa) by 2024, which translates to a requirement of 7 LNG storage tanks. Although Samsung C&T is charged for building the 4 tanks, home-grown companies like PEC may enjoy the rippling effect servicing the tanks in the long-haul, given its established presence on Jurong island..

3. Porters' Five Forces

PEC has 2 revenue reporting units: project works and plant maintenance & services. In assessing the 5 forces, we look at the management's strategy in enhancing PEC's competitiveness to increase shareholders' value.

Rivalry among existing competitors: High

There are numerous Engineering, Procurement and Construction (EPC) companies in Singapore which compete directly for clients' orders. As such, rivalry among existing competitors is high. However, successful allotment for larger projects tends to be bigger EPC players capable of more competitive bids. As PEC is a mid-sized player in EPC and consultancy management, they are still at the losing end to companies like Keppel FMO., CSE Global, Chiyoda, Ezra, Moya Dayen, Rotary and Swiber, all of which have specialized division for EPC and management.

According to Building and Construction Authority (BCA), PEC has tendering limits for all its business categories except Mechanical Engineering (L6), whereby it can tender unlimited amount of project. Unless it is granted higher tender permits, PEC cannot effectively compete with other players. On the other hand, PEC has diverse operation scope, which may be able to make up for its lost project scale.

COMPANY INFORMATION

COMPANY INFORMATION

PEC LTD.

UEN No.	:	198200079M
Address	:	21, SHIPYARD ROAD, Singapore 628144
Tel	:	62689788
Fax	:	62689488
Email Address	:	**info@peceng.com**

REGISTERED CONTRACTORS

WORKHEADS	DESCRIPTION	GRADE	EXPIRY DATE
CW02	Civil Engineering	C1	01/10/2014
ME02	Building Automation, Industrial & Process Control Systems	L3	01/10/2014
ME05	Electrical Engineering	L2	01/10/2014
ME11	Mechanical Engineering	L6	01/10/2014
SY08	Mechanical Equipment, Plant & Machinery	L3	01/10/2014

LICENSED BUILDERS

LICENSING CODE	DESCRIPTION	EXPIRY DATE
GB1	General Builder Class 1	16/06/2015
SB(SS)	Specialist Builder (Structural Steelwork)	16/06/2015

Tendering Limits

United Nations Public Service Award

Construction Workheads (CW01 and CW02)

	A1	A2	B1	B2	C1	C2	C3
Tendering Limit ($million) 1 Jul 11 to 30 Jun 12	unlimited	85.0	40.0	13.0	4.0	1.3	0.65
Tendering Limit ($million) 1 Jul 12 to 30 Jun 13	unlimited	85.0	40.0	13.0	4.0	1.3	0.65

Specialist Workheads (CR, ME MW and SY)

	L6	L5	L4	L3	L2	L1
Tendering Limit ($million) 1 Jul 11 to 30 Jun 12	unlimited	13.0	6.5	4.0	1.3	0.65
Tendering Limit ($million) 1 Jul 12 to 30 Jun 13	unlimited	13.0	6.5	4.0	1.3	0.65

Source: Building and Construction Authority

Threat of new entrants: Low

Project works & management consultancy segment is in a regulated arena. Hence, it will not be easy for new entrants to bid for larger projects. Moreover, new entrants may not enjoy economies of scale in employing specialized engineers capable of multi-tasking several similar projects. For plant maintenance & services segment, new entrants may be able to find their footing against PEC as these contracts do not fall under the strict purview of regulatory authority. However, AmFraser research analyst Lee Yue Jer postulated PEC has approximately 50% market share on Jurong Island. The dominance on the 40-hectare island forms strong barrier new entrants may find hard to break.

Availability of substitutes: High

There are numerous engineering contractors which offer similar services as PEC does to petrochemical and pharmaceutical industries. A random search on ST Directory lists at least 150 companies as engineering contractors - substitutes to the range of offerings PEC has. To increase market share, PEC could acquire similar-size horizontal companies or upstream integration to attack smaller-sized players such as Moya Dayen- competing on cost of providing engineering services.

Buyers' Power: Medium

In precision engineering, safety in implementation is one of the main considerations of outsourcing companies. PEC's focus on workplace safety & health standards is recognized with 17 accolades in the last fiscal year. Accordingly, this is one of the strongest selling points of the company. ExxonMobil has trusted PEC to deliver tank maintenance and repair services with a five-year contract, started September 2011. Beside, Shell Eastern Petroleum has also penned a two-year maintenance contract with PEC, started October 2012. The contracts of these 2 major petroleum players underline the confidence they have in PEC safety standards, more than cost of outsourcing the maintenance services.

In Nov '12, the company reported a contract win of $30 million. Earlier in Jul'12, the company announced $65 million contracts secured. Together, PEC has an estimated order book of $353 million, as of this report date. Thus, with an order-to-bill ratio of 0.99x, the company sees only a slight drop in demand. An order-to-bill ratio of more than 1 indicates demand exceeding project revenue billed; signaling future profitability when projects are completed.

Suppliers' Power: High

Major suppliers to PEC are manpower and material costs. Manpower costs have been increasing due to higher levies for foreign workers, shortage of skilled workers for projects as well as general wage inflation in Singapore. In mitigation of the increased cost, the company has diversified its operations overseas. Project works revenue derived from Singapore decreased from 83% in FY10 to 57% in FY12. However, higher wage rate is likely to continue squeezing margin even though the company has acquired subsidiaries in Myanmar to supplement revenue source. Labor force tightening in Singapore will continue to impact PEC negatively in FY13.

Procurement for materials is another area which exerts significant pressure on PEC's net profit margin. In a response to SGX queries, PEC disclosed material procurement increased 56.6% over the last fiscal year while revenue for project works increased 19.7%. The company has not made any significant engineering upstream acquisitions which may potentially lower the cost of materials. Therefore, suppliers' power to PEC is high.

Remarks

PEC's five-prong strategy focuses on enhancing revenue, which is somewhat misaligned with my assessment of the need to boost net profit margin. Nonetheless, the first strategy of diversifying operations away from Singapore has reaped decent results as Singapore is facing increased labor cost. There may be better margined projects elsewhere in Myanmar and China/Hong Kong.

The second strategy to keep a balanced revenue stream from both project works and plant maintenance services has not been achieved. Volatility has been sharp for both segments with growth 19.7% from a year ago, after reversing a decline of 13% from FY10 to FY11. Project works still accounts for approximately 2.5x of plant maintenance & services. Hence, the strategy needs to be evaluated on how best to achieve lower correlation between the 2 segments.

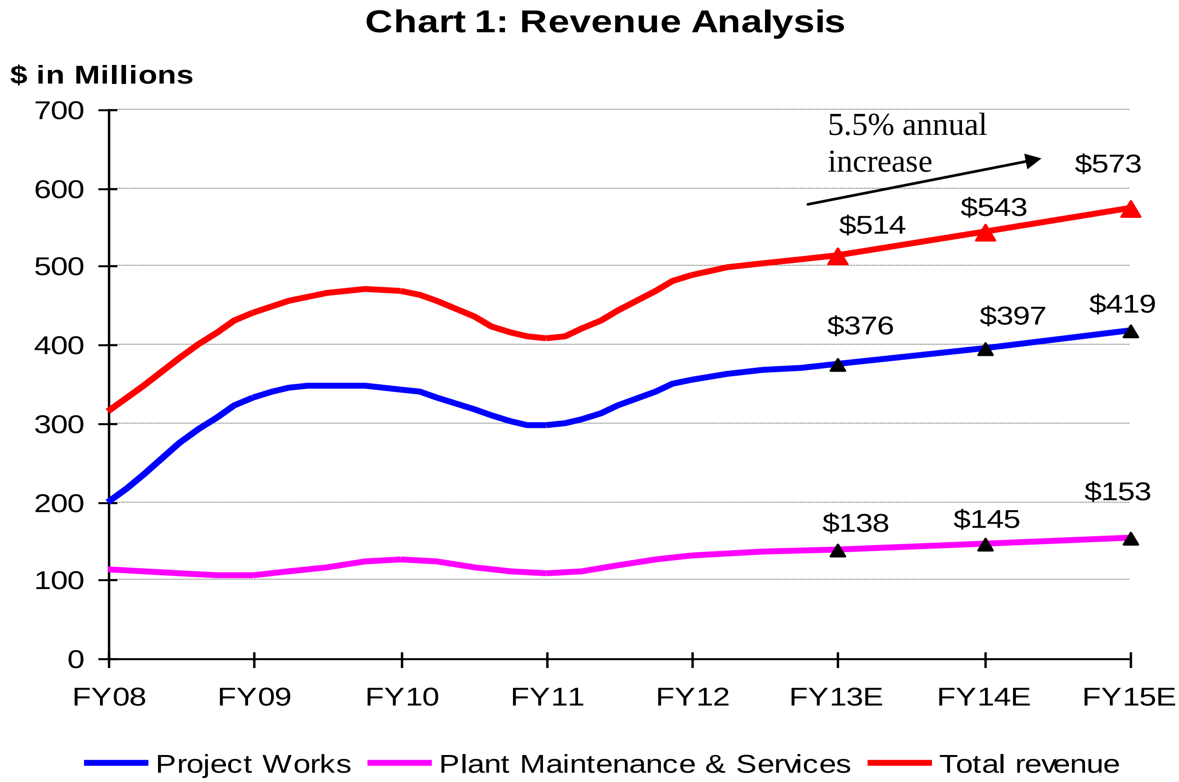
The third strategy of adding niche capabilities through joint ventures (JVs) and acquisitions has not been fruitful. PEC made sub-par investments with impairment losses incurred. According to the latest AR 2012, investment in subsidiaries had impairment of $3.4 million, $17 million for JVs (Verwater-Audex in Netherlands) and $1.3 million for investment in associates. Investment foresight warrants improvement.

The fourth strategy of deepening existing engineering capabilities will help PEC in revenue depth. Noticeably, some of the contracts won were from existing clients. Thus, as clients' needs change, it is necessary for PEC to keep up or it will lose invaluable consultant-client relationships.

The fifth strategy is to explore adjacent industries in the energy and upstream oil & gas sectors. The uncertain global economic outlook casts a shadow on global energy demand. The strategy may boost its revenue given that PEC has strong onshore capabilities to leverage on. Should the company be able to support offshore exploration projects, the company could directly compete with companies such as Ezra Holdings and Swiber.

Evident from the above, PEC does not have a strong market position besides its workplace safety proposition. Although it has a decent order-to-bill ratio of 0.99x, it may be wise to improve revenue in the near-term but the long-term objective is to improve profitability. An order-to-bill ratio of 1.2x may be comfortable (estimated order book of $426 million). Undoubtedly, a balanced revenue stream and strategic investments are important in the hunt for greater market share in process engineering. However, these two of the five-prong strategy have not been successful to date. Attention to margins is of greater importance than improving revenue at the expense of lower profitability. This is detrimental to shareholders' value.

4. Financial Analysis

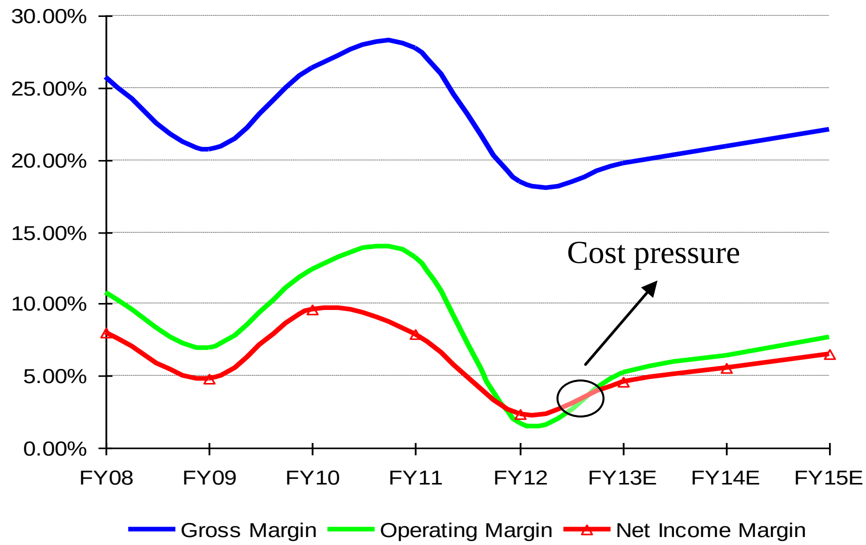


Source: Annual reports, VPM estimates

As of Nov 1, 2012, excluding maintenance contracts, PEC has an order book of $353 million. Revenue growth from FY2011 to FY2012 was 19.7% average for both Project Works and Plant Maintenance units. The higher growth was a result of more contract won, possibly at a lower bidding price and squeezing on gross profit margin. With a modest revenue growth rate of 5.5% given the current economic backdrop, Chart 1 shows the forecasted Revenue trend.

The increased labor cost across the board, from higher foreign workers' levy to shortage of skilled labor, has put significant pressure on margins. Accordingly, as can be seen in Chart 2, net income margin indicated by Red Line is likely to lag operating margin on increased labor cost. The gradient of net income margin may increase should management achieve synergy in supply-chain acquisition or exogenous factors such as government jobs credit grant were to return.

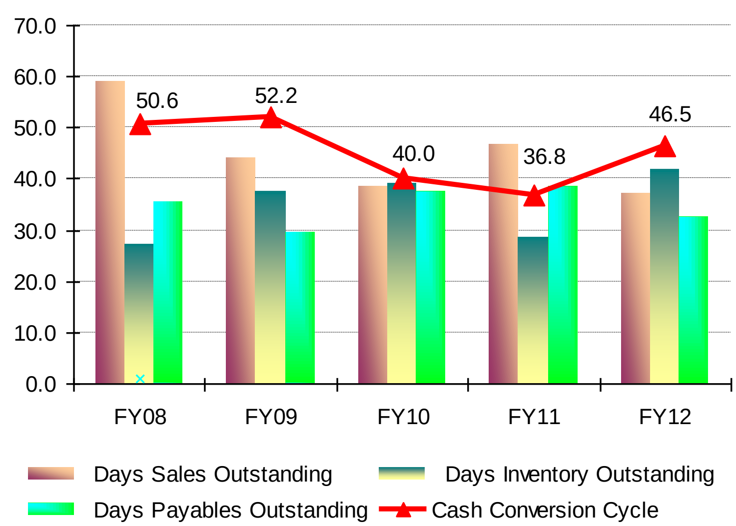
Chart 2: Margin Analysis



Source: Annual reports, VPM estimates

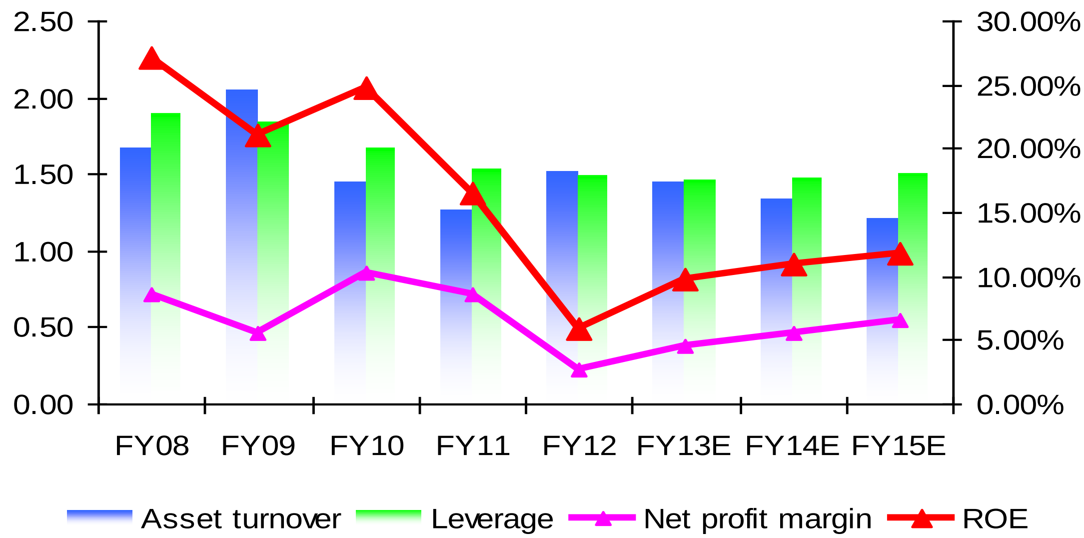
Chart 3 below shows the average days taken for cash conversion. For the last reported fiscal year, days taken to convert cash increased to 46.5 days from 36.8 days. In addition, inventory outstanding had a notable increase, which increases the risk of inventory write-down. One positive from Chart 3 is the decrease in Days Sales Outstanding. The decrease has reduced the risk of bad debt, though in FY2012, PEC has written off $17 million bad debt.

Chart 3: Cash Conversion Cycle



Source: Annual reports

Chart 4: DuPont Analysis



Source: Annual reports, VPM estimates

Chart 4 shows the DuPont analysis of PEC with projections for Asset turnover, Leverage and Net Profit Margin. For the 5-year period ending FY 2012, total assets have increased 70% compared with total revenue which increased 55%. As a result, asset efficiency decreased as indicated by asset turnover.

A significant portion of its asset is held in cash but not functional assets. Thus, most of the retained earnings are in cash without investments for higher returns. Leverage has been in steady decline from FY08 to FY12. Moving forward, PEC has sufficient space to increase leverage for achieving a higher ROE.

Over the same 5-year period, net profit margin decreased from 8.6% to 2.6%. This implies significant cost pressure on PEC's bottom-line, as we have alluded to, hence negatively affected the ROE. Projecting a base-case 4.6% net income margin for FY13, ROE is likely to be about 9.7%, ceteris paribus.

5. Valuations

Singapore risk-free rate of return invested in 10-year SGS Bond yields about 1.8%. Applying a beta of 1.2, market return of 9% and a liquidity premium of 2.5%, my required rate of return for PEC:

Required return for equity = 1.8+ 1.2(9.0-1.8) +2.5
= 12.94%

Estimated terminal growth rate is 6.5% due to PEC operating in the competitive landscape. As PEC distributes approximately 22% of its net income, VPM estimate for terminal dividend growth rate to be 7% instead. The current book value of PEC is $0.81.

Table 1: Valuation Models

	FY13E	FY14E	FY15E	Terminal Value	Final Valuation
Free Cash Flow Equity	0.037	0.059	0.036	0.600	$0.733
Dividend Discount	0.027	0.027	0.024	0.438	$0.516
Residual Income	-0.030	-0.020	-0.013	Book Value: 0.807	$0.745

Source: VPM estimates

Table 2: Price Multiples Valuation

	PEC
EPS	0.0448
Book Value	0.8075
Cash Flow	0.0939
Sales	1.9096

x

	Industry	Price	Allocation	Valuation
P/E	8.98	0.403	20%	$ 0.88
P/B	1.35	1.090	30%	
P/CF	5.95	0.559	30%	
P/S	0.80	1.518	20%	

Source: AR2012, Thomson Reuters, Bloomberg

Among the 4 valuation methodologies, residual income valuation is the most relevant in PEC's case. Free cash flow to equity is not stable due to higher amount of trade receivables. In addition, the large amount of cash held on hand, $0.45/share, does not provide a meaningful estimation of its true operation value. Since the company declared its first dividend in 2010, dividend has been declining from $0.04 to $0.025. I opine that this is in line with the management prudence in cash management. Should market condition improve, dividend to common shareholders may not increase. With the large amount of cash held on hand, price multiples valuation is more relevant as a measure of take-over value.

Residual income model reflects the tepid growth confronting the global economy, with income not able to cover the cost of equity. However, the strong balance sheet position acts as buffer should severe downturn occur. Hence, RI model is, among the others a better valuation model.

The industry multiples are calculated by using the averages of 4 listed companies with significant operations in the oil & gas sectors as shown in Table 3: Swiber, Keppel Corp, Ezra and CSE Global.

Table 3: Peer Group Comparison

	Price ($)	P/E	P/B	P/CF	P/S
PEC Ltd	0.600	13.37	0.74	6.39	0.31
Swiber Holdings	0.585	8.63	0.66	3.97	0.31
Keppel Corp	10.130	8.01	2.10	5.35	1.35
Ezra Holdings	1.025	11.73	0.81	7.40	0.78
CSE Global	0.790	7.56	1.83	7.09	0.74
Average excl PEC		8.98	1.35	5.95	0.80

Sources: Thomson Reuters, Bloomberg and IQ Capital

From the above tables, using RI model, PEC is trading at 24% discount to its intrinsic value. Therefore, PEC is a strong buy.

6. Key Assumptions

Revenue: I grew project works revenue in accordance to the growth of Singapore's GDP. In particular, I estimated Singapore's construction and manufacturing industries to expand at 5.2%. Thus, project works and maintenance & services business units in Singapore may grow at this rate. In addition, Asia Pacific ex Japan is likely to contribute 7% growth over previous year as Myanmar opens up and energy demand in Asia continues to increase.

Capital Expenditure: PEC's capex to sales ratio declined in FY2012 to 17%, from 19% a year ago. This was in line with management's expectation of a slowdown and hence decreased capex. In the coming years, as its order book strengthens, capex to sales ratio is likely to increase to 20%, 21.3% and 23.2% for subsequent years.

Net Working Capital: Consistent with stronger order book, working capital to sales ratio is likely to hold steady at 0.25x sales.

Debt Structure: PEC has negligible debt to equity ratio, at less than 1% as of FY 2012. I do not expect D/E to increase significantly in the coming years as the high net cash held could meet its acquisition and operation needs.

7. Risks

Liquidity presents a key risk for investing in PEC. With daily average volume of 200 lots changing hands everyday, it may be hard to liquidate large positions should negative (ie safety breaches) news hit PEC.

PEC’s joint venture with Verwater-Audex has not reaped in rewards for PEC because of $118 million cost overrun, and it is not likely to see positive result despite taking an impairment loss in FY2012. The JV has been a drag on PEC’s bottom line and dampened much euphoria of setting footprint at Netherlands, homeland of Group CEO Mr. Robert Dompeling.

The Board is not fully objectively independent from the management. Executive Chairman Ms Edna Ko is the wife of Robert Dompeling, Group CEO. Consequently, meetings may not be at the highest standard because such board meetings may be

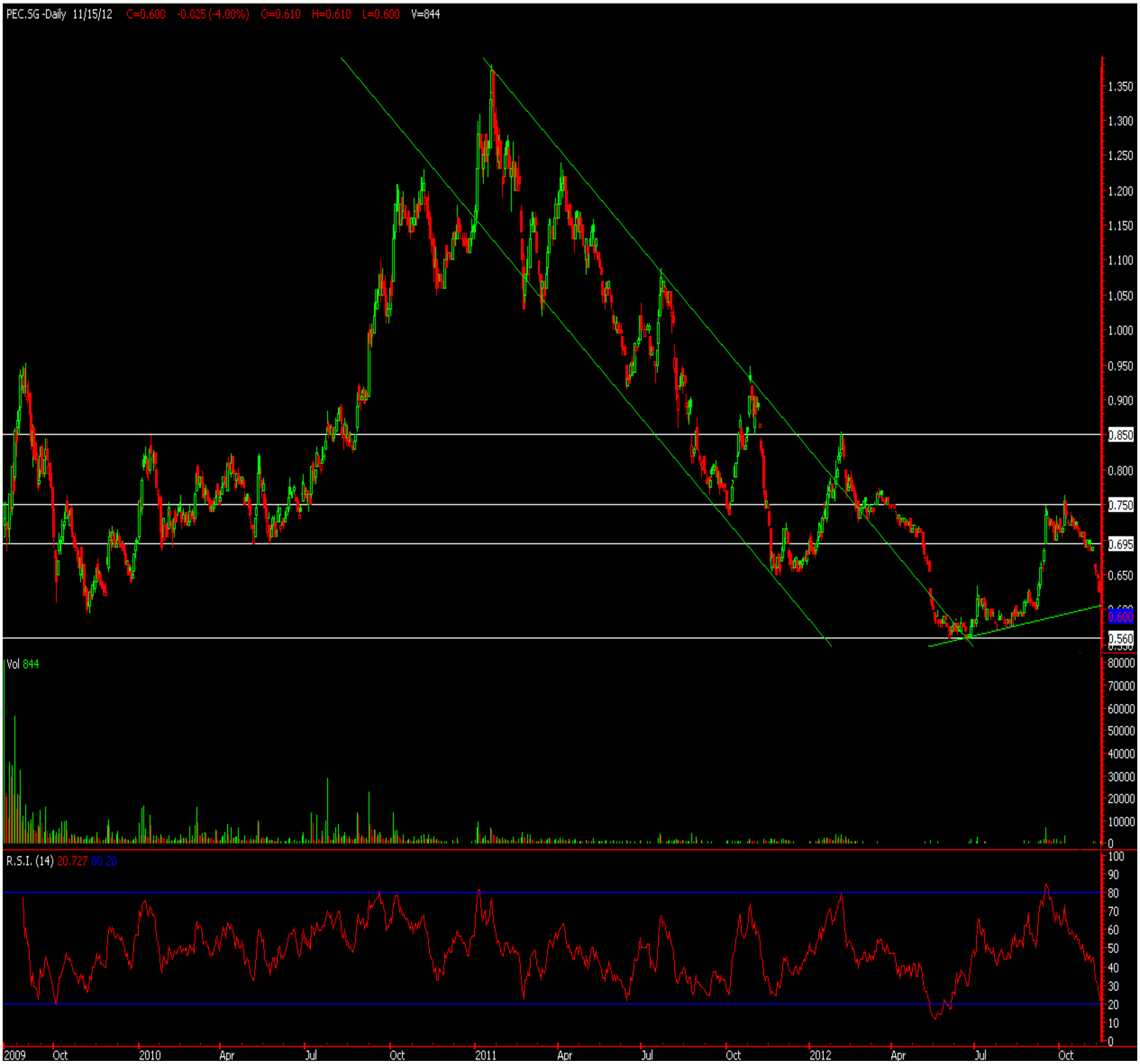
8. Technical Analysis

The technical chart below shows PEC is trading near its all-time low, which is not justifiable because the company’s financial statements were stronger than when it first listed. Notably, the cash position has more than doubled since its debut on Singapore Stock Exchange. The IPO price of PEC was $0.40.

Using high volume theory, PEC has a long-term resistance level at $0.85, established on Jul 27, 2010. With the same theory, it established a short-term range of $0.695- $0.75 on Sep 17, 2012. Since it went ex-dividend on Nov 8, 2012 giving investors 25 cents per share, the company’s shares have taken a dive breaking the mild up-trend support at $0.605 to close at $0.60.

Relative Strength Index (RSI) is close to 20% level, which typically signals a price reversion upwards. As such, it is a bullish indicator for PEC. When RSI makes a lower low than mid-May 2012, and price makes a higher low, the divergence is makes PEC a compelling technical buy..

To be safe, patient investors may wait for long-term support at $0.56 before taking a position. It is also at this level that the stock seen its 52-week low. For investors with spare cash after avoiding the “fiscal cliff” equity draw-down, the current price looks attractive for a small position. Short-term take profit point is $0.695, mid-term take profit at $0.75 and long-term at $0.85. Cut-loss price is to be set at $0.52, which, in my opinion, is of 20% probability.



9. Disclosures

I am long PEC. Further, I intend to accumulate shareholdings in the next 5 trading days.