# EQUITY RESEARCH

18th January 2018

Calamatta Cuschieri
INVESTMENT ADVISORS & STOCKBROKERS

## Medserv p.l.c.

**Executive Summary:**

***"We are initiating our coverage with a hold recommendation on Medserv plc ("MDS"). Despite the negative financial performance for FY17, because of delays in the execution of a number of contracts, we expect a significant improvement from 2018 mainly due to the execution of those contracts and a generally favourable outlook of the industry. The risk to the downside remain contract execution and the oil price. We view the stock as fairly priced in view of the above growth opportunities and risks."***

**Company Overview:**

MDS provides integrated logistics support and services to oil companies operating offshore primarily in the Mediterranean Sea (Malta and Cyprus). The Group mainly operates from its base in the Malta Freeport. The Group's main client is ENI OIL and ENI Gas. In Q1 2016 the Group added a new business line to its operations through the acquisition of Middle East Tubular Services Ltd. ("METS"). METS provides threading, inspection and repair services to the Oil Country Tubular Goods ("OCTG") industry in Iraq, Oman and United Arab Emirates.

**Business updates:**

The Group's performance in the past two years was impacted negatively by the decline in the oil price and oversupply of fossil fuel which resulted in the delay of drilling projects. Furthermore, METS Iraq is not performing well due to the instability in this region. Nonetheless the Group managed to secure a number of contracts which shall come to fruition in the next years.

*Libya* – Although the Group's Libya operations were minimal as a result of the political scenario in the region, the Group renewed a contract with an International Oil Company for two years to provide integrated shore base services for operations in Bahr Essalam field.

*Portugal* - In May 2016 the Group was awarded a contract by ENI to provide logistics and associated services for its exploration activities in the Alentejo Basin in Portugal. Drilling operations were delayed due to environmental issues, and are now expected for Q2 2018.

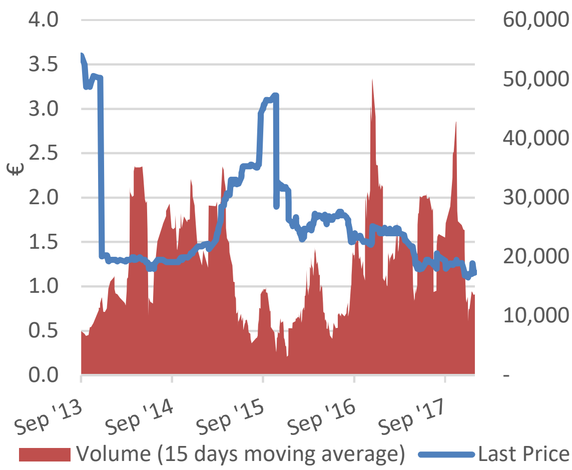
*Cyprus* – The Group operates from two bases located in Limassol and Larnaca. The Group informed that ENI extended its contract for operational base support services for its drilling operations in Cyprus. Operations started in December 2017.

| | |
|---|---|
| **Stock Rating** | **HOLD** |
| **Price target (1Yr)** | **€1.21** |

| | |
|---|---|
| **Country** | Malta |
| **Industry** | Oil and Gas support services |
| **Ticker** | MDS |
| **Price** | €1.16 |
| **Upside / downside to PT** | 4.8% |
| **Market Cap** | €62.3m |
| **Shares Outstanding** | 53.59m |
| **Free Float** | 25.8% |
| **Dividend Yield** | n/a |
| **Current P/E** | n/a |
| **Current EV/EBITDA** | 31.6x |
| **Forward EV/EBIT*** | 35.8x |

* CC estimates

| | |
|---|---|
| **Price Movement** | Exchange MSE |
| **52-week Range** | €1.101 - €1.660 |




*Source: Malta Stock Exchange*


**Market Research**

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*Oman* – METS was awarded a 5 year contract for the supply chain management of OCTG in Oman. In this occasion the Group opened a new facility at the new port of Duqm, which started to operate during December 2017.

## SWOT Analysis

### Strengths

- ✓ Good geographical position to support drilling operations in North Africa and Eastern Mediterranean.
- ✓ Following the acquisition of METS the Group is more diversified both from a geographical and product point of view.
- ✓ The Group secured a number of contracts that are now coming to fruition or are expected to do so during 2018.
- ✓ The Iraq business venture is the sole VAM® licensed workshop in the country[1].

### Weaknesses

- ✗ Short term nature of contracts.
- ✗ High volatility of revenue from logistics operations due to the fluctuations in the oil price which significantly impacts the drilling activity.
- ✗ Instability in Iraq are leading to losses in this region.
- ✗ Low liquidity of the stock.

### Opportunities

- The Group is actively seeking new business opportunities in new geographical areas through its new offices in Trinidad, Tobago and Egypt.
- Cross-selling opportunities with METS.
- The Group is in advanced stages to conclude a strategically important long-term contract for the provision of shore base services in a new geographical area.
- Oil prices expected to rise in 2018, creating a favourable scenario for service companies.

### Threats

- ! Delays in drilling operations for which service contracts have already been secured.
- ! Increasing attention to environmental issues further contributing to delaying and/or reducing drilling activity.
- ! Potential decline in oil price (stressed by oversupply) reducing investments in drilling operations as well as demand for related support services.
- ! Decline in the oil industry replaced by alternative energy sources (e.g. renewable energies and nuclear).

## Investment Stance

We are initiating our coverage with a hold recommendation on MDS. In the past years two years the Group suffered from the drop in the oil price observed between 2014 and 2016, which, led to a reduction in the drilling activity. After a slow recovery in 2017, the oil price is expected to continue to rise in 2018. Accordingly, following negative financial performances for FY17, we expect a significant improvement from 2018 if a number of contracts currently on hold are executed. The Group has indeed a number of growth opportunities stemming from the drilling activity in Cyprus, Portugal and North Africa as well as from the operations in the Middle East, whereby a

[1] The VAM® licensee network consists of certified repair shops that thread premium connections of the same quality and performance as those delivered from the production facilities of VALLOUREC OIL and GAS FRANCE.

long term contract for OCTG services was awarded to MDS during 2017. Furthermore, MDS is actively seeking new business in new geographical areas by participating to tendering processes.

However, there is an element of concern in terms of contract execution and/or delay attributable to increased attention to environmental issues and the general volatility of the oil price and production which may significantly affect the Group's operations. Hence we believe that the current stock price is already reflecting the Group's growth potential and the industry's risks.

MDS is currently trading at 31.6x 2017 LTM EV/EBITDA and at 35.8x 2017F EV/EBITDA, which is above its two and five years historical average of 17.1x and 17.4x respectively. We attribute these high multiples to the opportunities contracted by the Group between 2016 and 2017. Since we expect these contracts to be executed during 2018 we believe that the stock should now be trading more in line with its historical and peers' multiples at 17.1x.

## Investment Thesis Variables

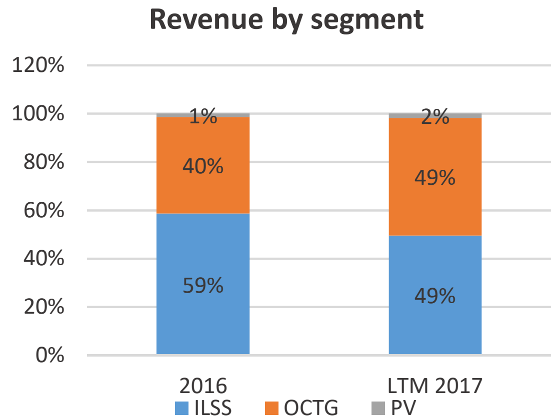
| FY Ending | 2015A | 2016A | LTM 2017 | 2017F | 2018P | 2019P |
|---|---|---|---|---|---|---|
| | €'000 | €'000 | €'000 | €'000 | €'000 | €'000 |
| Revenue | **42,721.7** | **32,822.3** | **29,141.5** | **26,615.7** | **42,481.7** | **41,032.2** |
| Cost of sales | (29,762.9) | (28,244.7) | (26,216.0) | (24,137.5) | (32,158.7) | (31,225.5) |
| Administrative expenses | (5,366.1) | (5,141.7) | (6,157.6) | (5,623.9) | (5,741.3) | (5,608.7) |
| Other income | 39.0 | 573.2 | 663.4 | 213.0 | - | - |
| Other expenses | (110.9) | - | - | - | - | - |
| EBIT | **7,520.9** | **9.1** | **(2,568.6)** | **(2,932.7)** | **4,581.8** | **4,198.0** |
| Depreciation and amortisation | 2,650.2 | 5,518.9 | 6,191.9 | 5,982.2 | 5,319.5 | 5,187.0 |
| EBITDA | **10,250.7** | **5,401.4** | **3,456.4** | **3,049.5** | **9,901.3** | **9,384.9** |
| Finance costs | (1,507.8) | (2,847.8) | (3,018.4) | (3,019.8) | (2,933.1) | (2,933.1) |
| Finance income | 3.5 | 384.4 | (129.4) | 14.9 | - | - |
| Profit Before Tax | **6,016.5** | **(2,454.2)** | **(5,716.4)** | **(5,937.6)** | **1,648.7** | **1,264.9** |
| Income tax expense[2] | (1,306.2) | 5,431.3 | 4,939.0 | 361.1 | (136.7) | (95.4) |
| Loss from discontinued operations | (218.5) | - | - | - | - | - |
| Profit available to Shareholders | **4,491.8** | **2,977.1** | **(777.5)** | **(5,576.5)** | **1,512.0** | **1,169.5** |
| EPS | 0.100 | 0.055 | (0.014) | (0.104) | 0.028 | 0.022 |
| Ratios | | | | | | |
| *Revenue growth* | *32.6%* | *-23.2%* | *-11.2%* | *-18.9%* | *59.6%* | *-3.4%* |
| *EBITDA margin* | *24.0%* | *16.5%* | *11.9%* | *11.5%* | *23.3%* | *22.9%* |
| *EBIT margin* | *17.6%* | *0.0%* | *-8.8%* | *-11.0%* | *10.8%* | *10.2%* |
| *Net margin* | *10.5%* | *9.1%* | *-2.7%* | *-21.0%* | *3.6%* | *2.9%* |

*Source: Company's audited financial statement, HY report and CC's estimates*

- **Revenue –**
  - **ILSS** – expected to decrease to €11 million in FY17F (FY16: €19 million) mainly due to delays in drilling operations in Portugal and Cyprus and reduced activity in Libya. We expect ILSS revenue to increase to €22 million in FY18P as a result of resumed operations in Cyprus, Portugal and North Africa. We decreased FY19P ILSS revenue to €20 million since the contract with ENI in Portugal has a 1Y duration.

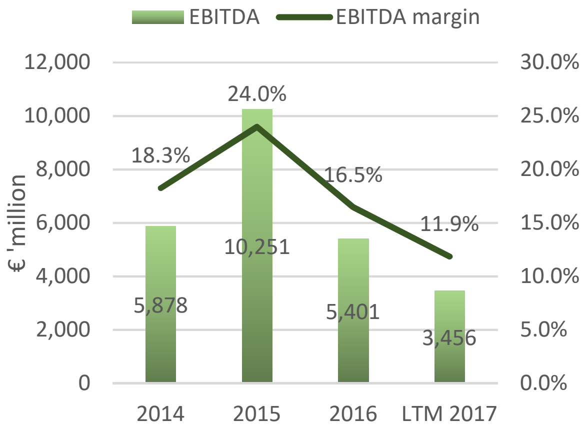
[2] Over the past years the Group has benefited from investment tax credits, which significantly reduced the tax level. In our projections we applied an average tax rate based on the corporate tax rates applicable in the countries where the Group operates weighted by the estimated EBITDA contribution from the relevant country.

- **OCTG** – estimated at €15 million for FY17F (FY16: €13 million for ten months). We expect OCTG revenue to increase to €19.6 million as a result of the increased activity especially in Oman, whereby a five year contract was awarded to METS in Q1 2017. We expect the OCTG revenue to further increase to €20.5 million as a result of the favourable outlook of the industry.
- **PV** – expected at €589k in FY17F following positive results in H1 2017, and in line with past performances at €533k for FY18P and FY19P.
- **Other income** – other income primarily consists of exchange differences. We forecasted €213k other income in FY17F as per HY results and no other income for FY18P and FY19P.



*Source: Company's audited financial statement and HY report*

- **Cost of sales –** Assumed to decrease to €24 million in FY17F (FY16: €28 million) as a result of the reduced operations, although not in line with revenues. We expect the cost of sales to increase to €32 million and €31 million in FY18P and FY19P following an increase in operations.
- **Depreciation and amortisation –** expected to increase to €5.9 in FY17F as a result of the increased amortisation charge for the two signing bonuses of a total value of €3.2 million granted to two key management personnel of METS in FY16. The depreciation and amortisation charge is expected to decrease to €5.3 million in FY18 due to the full amortisation of one signing bonus by February 2018.
- **Margins:**
  - **EBITDA margin –** expected to decrease to 11.5% in FY17F (FY16: 16.5%), due to the low level of operations, and increase in FY18P and FY19P to 23.3% and 22.9% respectively thanks to the execution of contracts that were delayed so far.
  - **EBIT margin** – The Group's LTM EBIT margin was negative at -8.8% compared to 78.2% for the full and nil in FY16 because of the reduced revenue. We expect the EBIT margin to remain negative at -11.0% in FY17F and improve to 10.8% and 10.2% in FY18P and FY19P respectively.



*Source: Company's audited financial statement and HY report*

- **Tax rate –** we applied an average tax rate of 6.1%, 8.3% and 7.5% in FY17F, FY18P and FY19P. Our average tax rate was based on the corporate tax rates applicable in the countries where the Group operates weighted by the estimated EBITDA contribution from the relevant country.

## Valuation

Our 1yr price target is €1.21. The price target is calculated using an EBITDA valuation approach with a forward EV/EBITDA multiple of 17x and a discount rate (weighted average cost of capital) of 10.5%.
The EV/EBITDA multiple reflects the two (17.1x) and five (17.4x) year historical multiple for MDS as well as the multiple for comparable companies (16.7x).

The wacc reflects, amongst other, the cost of debt, the high leverage of the Group and the riskiness of the industry and MDS itself.

## Key Financial Indicators

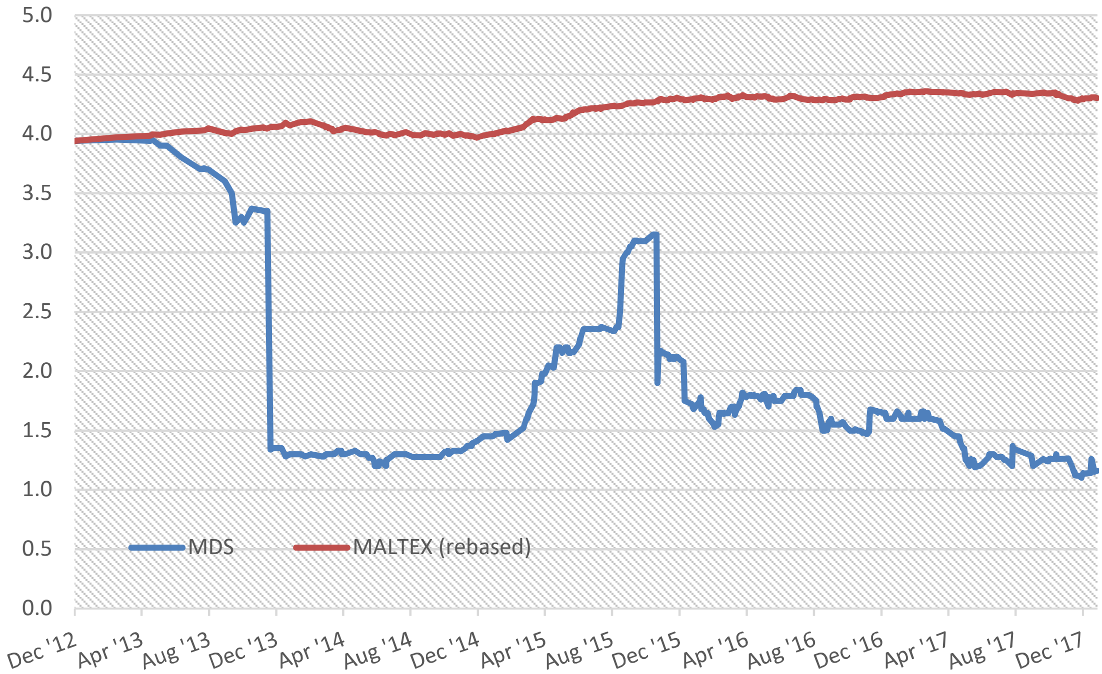
| | 2014 | 2015 | 2016 | LTM 2017 | H1 2016 | H1 2017 |
|---|---|---|---|---|---|---|
| | € 'million | € 'million | € 'million | € 'million | € 'million | € 'million |
| Income Statement | | | | | | |
| Revenue | 32,207 | 42,722 | 32,822 | 29,141 | 17,301 | 13,620 |
| Gross Profit | 5,878 | 10,251 | 5,401 | 3,456 | 3,547 | 1,601 |
| Operating Income (EBIT) | 4,216 | 7,521 | 9 | (2,479) | 1,086 | (1,402) |
| Net Income | 2,186 | 4,492 | 2,977 | (688) | 218 | (3,447) |
| EPS (No. shares as at year end) | 0.087 | 0.100 | 0.055 | (0.013) | 0.004 | (0.064) |
| Dividend / Share | 0.056 | 0.089 | 0.000 | 0.000 | 0.000 | 0.000 |
| Growth in Revenue (YoY) | 369.4% | 32.6% | -23.2% | -11.2% | -36.4% | -21.3% |
| EBITDA Margin | 18.3% | 24.0% | 16.5% | 11.9% | 20.5% | 11.8% |
| EBIT Margin | 13.1% | 17.6% | 0.0% | -8.5% | 6.3% | -10.3% |
| Net Margin | 6.8% | 10.5% | 9.1% | -2.4% | 1.3% | -25.3% |
| Balance Sheet | | | | | | |
| Cash and Cash Equivalents | 1,116 | 1,037 | 6,218 | 4,974 | 7,215 | 4,974 |
| Current Assets | 18,532 | 19,466 | 26,561 | 23,957 | 32,282 | 23,957 |
| Non-Current Assets | 62,304 | 61,675 | 94,892 | 90,991 | 89,097 | 90,991 |
| Total Assets | 80,836 | 81,141 | 121,453 | 114,949 | 121,378 | 114,949 |
| Current Liabilities | 15,250 | 13,299 | 8,361 | 7,279 | 10,655 | 7,279 |
| Non-Current Liabilities | 56,113 | 56,720 | 86,684 | 85,727 | 87,687 | 85,727 |
| Total Liabilities | 71,363 | 70,019 | 95,045 | 93,006 | 98,342 | 93,006 |
| Net Debt | 24,903 | 25,156 | 46,950 | 47,225 | 8,785 | 47,225 |
| Total Equity | 9,473 | 11,122 | 26,408 | 21,943 | 23,036 | 21,943 |
| Return on Common Equity[3] | 23.1% | 40.4% | 11.3% | -3.1% | 12.9% | -3.1% |
| Return on Assets | 2.7% | 5.5% | 2.5% | -0.6% | 2.5% | -0.6% |
| Current Ratio | 1.2 | 1.5 | 3.2 | 3.3 | 3.0 | 3.3 |
| T. Liabilities / T. Assets | 88% | 86% | 78% | 81% | 81% | 81% |
| Net Debt / Total Equity | 263% | 226% | 178% | 215% | 38% | 215% |
| Cash Flows | | | | | | |
| Cash from Operations | (2,808.7) | 8,825 | 7,350 | 7,077 | 1,604 | 1,332 |
| CAPEX (recurring) | (13,431.2) | (3,819) | (1,657) | (380) | (1,277) | (265) |
| Free Cash Flow | (16,239.9) | 5,006 | 5,693 | 5,536 | 1,224 | 1,067 |
| Net cash movement | (8,372.6) | 1,203 | 8,155 | (485) | 7,688 | (952) |
| Net Debt/CFO | (8.9) | 2.9 | 6.4 | 6.7 | 5.5 | 35.5 |
| CFO/EBIT | -67% | 117% | 80730% | -285% | 148% | -95% |

*Source: Company's audited financial statement and HY report*

[3] ROE and ROA for H1 2016 takes into consideration the full year FY17 performance, ROE and ROA for H1 2017 refer to the LTM 2017 performance.

## Historical Price

| Reference | Date | Price | Price Target | Analyst | Recommendation |
|---|---|---|---|---|---|
| MDS | 10.01.2018 | €1.16 | €1.21 | Elisabetta Gaudiano | Hold |




*Source: Bloomberg*

## Glossary and Definitions

| | |
|---|---|
| **Income Statement** | |
| EBITDA | EBITDA is an abbreviation for earnings before interest, tax, depreciation and amortisation. EBITDA can be used to analyse and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. |
| Profit after tax | Profit after tax is the profit made by the Group during the financial year both from its operating as well as non-operating activities. |
| **Profitability Ratios** | |
| Operating profit margin | Operating profit margin is operating income or EBITDA as a percentage of total revenue. |
| Net profit margin | Net profit margin is profit after tax achieved during the financial year expressed as a percentage of total revenue. |
| **Efficiency** | |
| Return on Equity | Return on equity (ROE) measures the rate of return on the shareholders' equity of the owners of issued share capital, computed by dividing profit after tax by shareholders' equity. |
| Return on Assets | Return on assets (ROA) is computed by dividing profit after tax by total assets. |
| **Equity Ratios** | |
| Earnings per share | Earnings per share (EPS) is the amount of earnings per outstanding share of a company's share capital. It is computed by dividing net income available to equity shareholders by total shares outstanding as at balance sheet date |
| **Cash Flow Statement** | |
| Cash flow from operating activities | Cash generated from the principal revenue-producing activities of the Company, net of income tax and interest paid. |
| Cash flow from investing activities | Cash generated from the activities dealing with the acquisition and disposal of long-term assets and other investments of the Company. |
| Capital expenditure (CAPEX) | Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment, net of disposals and excluding non-recurring items. It is often used to undertake new projects or investments by the firm. |
| Free cash flows (FCF) | FCF is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base. |
| Cash flow from financing activities | Cash generated from the activities that result in change in share capital and borrowings of the Company. |
| **Balance Sheet** | |
| Non-current assets | Non-current asset are the Group's long-term investments, which full value will not be realised within the accounting year. Non-current assets are capitalised rather than expensed, meaning that the Group allocates the cost of the asset over the number of years for which the asset will be in use, instead of allocating the entire cost to the accounting year in which the asset was purchased. Such assets include intangible assets (goodwill on acquisition), investment properties, and property, plant & equipment. |
| Current assets | Current assets are all assets of the Company, which are realisable within one year from the balance sheet date. Such amounts include inventory, accounts receivable, cash and bank balances. |
| Current liabilities | All liabilities payable by the Company within a period of one year from the balance sheet date, and include accounts payable and short-term debt. |
| Net debt | Borrowings before unamortised issue costs less cash and cash equivalents. |
| Non-current liabilities | The Company's long-term financial obligations that are not due within the present accounting year. The Company's non-current liabilities include bank borrowings and bonds. |
| Total equity | Total equity includes share capital, reserves & other equity components, and retained earnings. |

| Financial Strength Ratios | |
|---|---|
| Liquidity ratio | The liquidity ratio (also known as current ratio) is a financial ratio that measures whether or not a company has enough resources to pay its debts over the next 12 months. It compares a company's current assets to its current liabilities. |
| Interest cover | The interest coverage ratio is calculated by dividing a company's EBITDA of one period by the company's interest expense of the same period. |
| Net debt / Equity | Net debt / equity ratio is a debt ratio used to measure a company's financial leverage, calculated by dividing a company's net debt by its stockholders' equity. This ratio indicates how much net debt a company is using to finance its assets relative to the amount of value represented in shareholders' equity. |

## Explanation of Equity Research Ratings

**Buy:** Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.

**Sell:** Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock.

**Hold:** We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Newly issued research recommendations and target prices supersede previously published research

## Disclaimer