

## SPT Energy Group Inc.

More headwinds from CNPC's deeper capex cut; high balance sheet risk

**We assume coverage of SPT at UW (from Neutral) with a revised Dec-16 PT of HK\$0.30.** The major risk we see is deeper-than-expected capex reductions at major client CNPC (including PetroChina) in 2016.

- **Client risk.** We expect 20%+ capex reductions at CNPC/PetroChina in 2016, more than the market expects, as low oil prices have led China's largest oil producers to close wells. As the market shrinks, CNPC/PetroChina could also increase the amount of insourcing (compared with the current strategy of outsourcing). CNPC has historically provided 80%+ of SPT's revenue, so a further slowdown in CNPC work is a major risk to SPT's growth.
- **Market risk.** SPT derives almost all its revenue from China and Kazakhstan. With noticeable order slowdowns and Central Asia currency an added concern, SPT has suffered heavier losses than peers, and we do not expect major improvements in the near term.
- **Cash flow risk heightened.** With >Rmb400mn in net losses expected for 2015 and a similar level over the next two years, SPT's cash flow is now a big concern. We forecast negative EBITDA from 2015 and Rmb55mn net cash in 2016 turning into c.Rmb600mn net debt in 2017. As banks try to avoid small OFS companies, refinancing will be a challenge, in our view.
- **Valuation.** The stock currently trades at a 0.9x FY16E P/B (industry 0.7x) and 2.8x EV/sales (industry 1.8x). Our Dec-16 PT of HK\$0.30 is derived from blended multiples, including P/B and EV/sales, as EBITDA is projected to be negative.
- **Earnings preview.** We forecast a 51% revenue decline and a net loss of Rmb451mn in 2015. We expect SPT to continue making losses in 2016.

### ▼ Underweight

Previous: Neutral

1251.HK, 1251 HK

Price: HK\$0.60

### ▼ Price Target: HK\$0.30

Previous: HK\$0.70



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#### Price Performance



#### SPT Energy Group Inc. (Reuters: 1251.HK, Bloomberg: 1251 HK)

Rmb in mn, year-end Dec	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (Rmb mn)	2,415	2,169	1,067	927	908
Net Profit (Rmb mn)	300	116	(451)	(410)	(444)
EPS (Rmb)	0.20	0.08	(0.29)	(0.27)	(0.29)
DPS (Rmb)	0.05	0.02	0.00	0.00	0.00
Revenue growth (%)	33.4%	(10.2%)	(50.8%)	(13.1%)	(2.1%)
EPS growth (%)	6.8%	(61.5%)	(488.3%)	(9.2%)	8.4%
ROCE	16.5%	6.7%	(20.7%)	(25.5%)	(35.1%)
ROE	17.8%	6.5%	(29.1%)	(36.6%)	(64.2%)
P/E (x)	2.5	6.6	NM	NM	NM
P/BV (x)	0.5	0.4	0.6	0.9	1.8
EV/EBITDA (x)	1.1	3.1	NM	NM	NM
Dividend Yield	9.5%	3.9%	0.0%	0.0%	0.0%

Source: Company data, Bloomberg, J.P. Morgan estimates.

#### Company Data

Shares O/S (mn)	1,535
Market Cap (Rmb mn)	769
Market Cap (\$ mn)	119
Price (HK\$)	0.60
Date Of Price	18 Mar 16
Free Float(%)	44.0%
3M - Avg daily vol (mn)	1.16
3M - Avg daily val (HK\$ mn)	0.72
3M - Avg daily val (\$ mn)	0.1
HSCEI	8773.83
Exchange Rate	7.76
Price Target End Date	31-Dec-16
Price Target (HK\$)	0.30

**See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.**

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19 March 2016

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<b>Key catalysts for the stock price:</b> 1) Client capex cut announcement 2) Consensus downgrades	<b>Upside risks to our view:</b> Lower-than-expected capex reductions at E&P clients, higher margins due to improved efficiencies and a rapid rebound in global oil prices	<b>Downside risks to our view:</b> 1) Excessive market/client concentration 2) Earnings deterioration, worsening cash flow and balance sheet
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Key financial metrics	FY14	FY15E	FY16E	FY17E
Revenues (LC mn)	2,169	1,067	927	908
Revenue growth (%)	(10%)	(51%)	(13%)	(2%)
EBITDA (LC mn)	287	(355)	(308)	(302)
EBITDA margin (%)	13%	(33%)	(33%)	(33%)
Tax rate (%)	29%	(7%)	(0%)	(0%)
Net profit (LC mn)	116	(451)	(410)	(444)
EPS (LC)	0.08	(0.27)	(0.24)	(0.26)
EPS growth (%)	(59%)	NM	NM	NM
DPS (LC)	0.02	-	-	-
Operating cash flow (LC mn)	(91)	220	(18)	(580)
Free cash flow (LC mn)	(232)	194	(57)	(567)
Net margin (%)	5%	(42%)	(44%)	(49%)
Sales/assets (X)	0.7	0.3	0.4	0.5
Debt/equity (%)	27%	66%	14%	155%
Net debt/equity (%)	(4%)	(9%)	(6%)	118%
ROE (%)	7%	(29%)	(37%)	(64%)

Source: Bloomberg, Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA	EPS
Sensitivity to	FY16E	FY16E
1% chg. in EBITDA margins	1%	2%

Source: J.P. Morgan estimates.

#### Valuation and price target basis

Our Dec-16 PT of HK\$0.30 is derived from blended multiples, including P/B and EV/sales, as EBITDA is projected to be negative.

#### Price Target Breakdown

Multiple	P/B	EV/EBITDA	EV/sales
(x)	0.6	6.0	1.6
Derived EV (RMB mn)	2,260	NA (negative EBITDA)	1,483
Weighted EV (RMB mn)	2,144		
Net debt (RMB mn)	1,691		
Equity Value (RMB mn)	453		
Price target (HK\$)	0.3		

Source: J.P. Morgan estimates.

#### JPM vs. consensus, change in estimates

EPS	FY15E	FY16E
JPM old	(0.05)	0.09
JPM new	(0.27)	(0.24)
% chg.	NM	NM
Consensus	(0.21)	(0.02)

Source: Bloomberg, J.P. Morgan estimates.

#### China Oil and Gas coverage comparative metrics

	Mkt Cap \$bn	P/E		EV/EBITDA		P/BV		YTD Stock perf.
		FY15	FY16	FY15	FY16	FY15	FY16	
PetroChina (OW)	209.9	17.8	10.5	4.6	3.7	0.7	0.6	6%
CNOOC (N)	84.2	11.7	8.7	2.3	1.9	0.8	0.8	14%
Sinopec Corp - H (OW)	50.0	18.0	8.7	4.8	3.5	0.8	0.8	4%
China Oilfield Services (UW)	7.6	24.4	21.4	12.0	11.9	0.6	0.6	(2%)
Sinopec Oilfield Service (UW)	11.5	739.7	105.7	20.6	22.1	0.9	0.9	(11%)
Offshore Oil Engineering (N)	4.8	10.8	12.0	6.2	7.2	1.4	1.3	(18%)
Hilong Holdings (UW)	0.2	5.4	5.0	5.6	5.5	0.4	0.4	(21%)
Anton Oilfield Services (UW)	0.2	NA	40.5	10.6	7.1	0.7	0.7	8%
SPT Energy Group Inc. (UW)	0.1	NA	NA	NA	48.7	0.5	0.6	(13%)
Honghua Group (UW)	0.2	NA	NA	10.4	8.7	0.3	0.3	(11%)

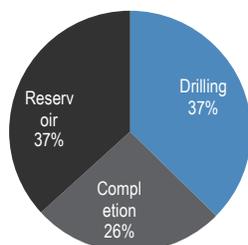
Source: Bloomberg, J.P. Morgan. Prices are as of 2016-03-18

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Figure 1: SPT's revenue breakdown



Source: Company data.

## Investment Thesis, Valuation and Risks

### SPT Energy Group Inc. (Underweight; Price Target: HK\$0.30)

#### Investment Thesis

SPT Energy Group is one of China's independent oilfield service providers, with customers in China and internationally, mainly in Turkmenistan and Kazakhstan. The firm has leverage to local SOEs (mainly PetroChina/CNPC), which is its main client, and has a strategic alliance and JV with Halliburton. SPT provides integrated oilfield services ranging from reservoir research to drilling, well completion and well testing. SPT also manufactures and sells oilfield service-related products. Our negative view is based on:

- **Limited domestic order visibility...** The company has limited order visibility for the medium term; and there is a threat that it will be impacted by cuts at E&Ps in China and Central Asia. CNPC's deeper-than-expected capex reduction is a key risk, as it is SPT's major revenue contributor in both China and abroad.
- **...in light of the growing threat from SOEs** – With SOEs' OFS competitors (e.g., SSC, CNPC Oilfield Service) looking to improve their own efficiencies and product offerings, we believe private service providers will see more pressure in securing contracts.
- **High default risk:** Due to SPT's high concentration on PetroChina/CNPC and weak markets (China and Kazakhstan), it incurred largest losses among comparable peers, and we forecast negative EBITDA from 2015 onward.

#### Valuation

Our Dec-16 PT of HK\$0.30 is derived from blended multiples, including P/B and EV/sales, as EBITDA is projected to be negative.

Multiple (x)	P/B 0.6x	EV/EBITDA 6.0x	EV/sales 1.6x
Derived EV (Rmb M)	2,260	N/A (negative EBITDA)	1,483
Weighted EV (Rmb M)	2,144		
Net debt (Rmb M)	1,691		
Equity Value (Rmb M)	453		
<b>Price target (HK\$)</b>	<b>0.3</b>		

Source: J.P. Morgan estimates.

#### Risks to Rating and Price Target

Upside risks include rapid oil price increases, lower-than-expected capex reductions at E&P clients, higher margins due to improved efficiencies and a rapid rebound in global oil prices.

## SWOT analysis

Figure 2: SPT Energy analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>Independent service companies should have more flexibility adjusting some variable costs, like staffing, in a slow market.</li> </ul>	<ul style="list-style-type: none"> <li>As an independent service provider, its smaller size will make it vulnerable to market volatility when there are still no clear signs of a demand recovery and SOEs increase in-sourcing to protect their in-house service arms.</li> <li>SPT's heavy concentration on Chinese NOCs for revenue flows make it a big risk, as these customers now tend to maximize in-sourcing to protect their in-house service arms. Its heavy concentration on PetroChina/CNPC and China/Kazakhstan has caused bigger losses at SPT than other comparables, and if this continues, its balance sheet would be the most stretched among Chinese OFS.</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>If PetroChina/CNPC plans increased capex budgets, SPT may have some opportunities (but we are not seeing this happening in the near future).</li> </ul>	<ul style="list-style-type: none"> <li>The industry may go through a multiyear slowdown due to excess oil supply globally and China's soft economic expansion, which leads to weaker oil demand growth.</li> <li>Chinese NOCs are restricting service volumes to in-house service arms, and that could be a major risk to all independent oilfield services companies operating at Chinese NOC projects, both domestically and internationally.</li> </ul>

Source: J.P. Morgan.

## Financial analysis

### Income statement

**Revenue decline.** We forecast a revenue decline of 51%/13% in 2015/16 vs. a four-year average expansion of 22%. The larger-than-peers' revenue decline in 2015E is due to SPT's excessive revenue contribution from clients PetroChina/CNPC and two weak markets, domestic China and Kazakhstan.

**Margin contraction.** We expect SPT's net margin to fall to -42%/-44% in 2015/16 due to drastic revenue declines and fixed costs. This compares with a four-year average of 11%.

### Balance sheet

**Asset returns.** We expect SPT's ROE to decline to -29%/-37% in 2015/16 vs. a four-year average of 14%. ROA may decline to -16%/-21% for 2015/16 vs. a four year average of 9%.

**Credit analysis.** We expect SPT's net gearing to reach -6%/+118%% in 2015/16. EBITDA may turn negative from 2015, a big concern.

### Cash flow

**FCF.** We expect negative FCF for 2016.

**Dividend.** We do not expect a dividend payout for 2015/16.

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Table 1: SPT earnings preview

Rmb in millions	2H14	1H15	2H15E	y/y	h/h
Drilling	400	111	114	(72%)	(72%)
Well completion	222	104	66	(70%)	(53%)
Reservoir	508	280	392	(64%)	(78%)
<b>Total revenue</b>	<b>1,130</b>	<b>495</b>	<b>572</b>	<b>(53%)</b>	<b>(56%)</b>
Operating cost	(923)	(718)	(788)		
Other operating (expenses) / income	(129)	(3)	3		
<b>Operating income</b>	<b>77</b>	<b>(225)</b>	<b>(213)</b>	<b>(277%)</b>	<b>(392%)</b>
Finance revenue / (expense)	(22)	(21)	(39)		
Other non-operating income (loss)	-	-	-		
<b>Pretax profit</b>	<b>55</b>	<b>(246)</b>	<b>(252)</b>	<b>(334%)</b>	<b>(546%)</b>
Taxes	(21)	35	-		
Tax rate	39%	NM	NM		
Non-controlling interests	(1)	(12)	(0)		
<b>Reported net income (ex-MI)</b>	<b>35</b>	<b>(199)</b>	<b>(252)</b>	<b>(345%)</b>	<b>(673%)</b>
<b>Reported net margin (ex-MI)</b>	<b>3%</b>	<b>NM</b>	<b>NM</b>		

Source: Company data, J.P. Morgan estimates.

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## SPT Energy Group Inc.: Summary of Financials

Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	2,415	2,169	1,067	927	908	EBIT	414	204	(438)	(417)	(401)
% change Y/Y	33.4%	(10.2%)	(50.8%)	(13.1%)	(2.1%)	Depr. & amortization	71	83	84	109	99
EBITDA	485	287	(355)	(308)	(302)	Change in working capital	(195)	(325)	600	294	(223)
% change Y/Y	15.6%	(40.8%)	(223.7%)	(13.1%)	(2.1%)	Taxes					
EBIT	414	204	(438)	(417)	(401)	Cash flow from operations	253	(91)	220	(18)	(580)
% change Y/Y	14.4%	(50.7%)	(314.7%)	(4.9%)	(4.0%)	Capex	(134)	(173)	(90)	(43)	(42)
EBIT Margin	17.1%	9.4%	(41.1%)	(45.0%)	(44.1%)	Disposal/(purchase)	-	-	-	-	-
Net Interest	(25)	(44)	(60)	(4)	(55)	Net Interest	(25)	(44)	(60)	(4)	(55)
Earnings before tax	389	160	(498)	(421)	(456)	Other	(21)	(33)	(19)	(16)	(16)
% change Y/Y	14.8%	(58.8%)	(410.6%)	(15.5%)	8.4%	Free cash flow	139	(232)	194	(57)	(567)
Tax	(81)	(46)	35	0	0	Equity raised/(repaid)	0	0	0	0	0
as % of EBT	20.8%	28.7%	(7.0%)	(0.0%)	(0.0%)	Debt raised/(repaid)	(49)	237	390	(776)	632
Net income (reported)	300	116	(451)	(410)	(444)	Other	(6)	107	0	0	0
% change Y/Y	21.3%	(61.3%)	(488.3%)	(9.2%)	8.4%	Dividends paid	(61)	(78)	0	0	0
Shares outstanding	1,528	1,533	1,533	1,533	1,533	Beginning cash	659	636	595	1,038	188
EPS (reported)	0.20	0.08	(0.29)	(0.27)	(0.29)	Ending cash	636	595	1,038	188	182
% change Y/Y	6.8%	(61.5%)	(488.3%)	(9.2%)	8.4%	DPS	0.05	0.02	0.00	0.00	0.00
Balance sheet						Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	636	595	1,038	188	182	EBITDA margin	20.1%	13.2%	(33.2%)	(33.2%)	(33.2%)
Accounts receivable	106	201	44	38	37	EBIT margin	17.1%	9.4%	(41.1%)	(45.0%)	(44.1%)
Inventories	485	550	352	434	336	Net margin	12.4%	5.4%	(42.3%)	(44.2%)	(48.9%)
Others	1,281	1,404	709	596	603						
Current assets	2,508	2,751	2,143	1,256	1,158	Sales per share growth	17.5%	(10.5%)	(50.8%)	(13.1%)	(2.1%)
						Sales growth	33.4%	(10.2%)	(50.8%)	(13.1%)	(2.1%)
LT investments	-	-	-	-	-	Net profit growth	21.3%	(61.3%)	(488.3%)	(9.2%)	8.4%
Net fixed assets	373	604	613	550	496	EPS growth	3.1%	(59.3%)	(455.6%)	(10.1%)	7.3%
Total Assets	3,052	3,583	2,856	1,940	1,801	Interest coverage (x)	19.7	6.5	NM	NM	NM
Liabilities						Net debt to equity	(19.7%)	(4.0%)	(9.5%)	(5.8%)	118.2%
Short-term loans	190	460	903	127	760	Sales/assets	0.9	0.7	0.3	0.4	0.5
Payables	684	849	398	688	376	Assets/equity	1.6	1.9	2.1	2.1	2.7
Others	240	268	149	140	138	ROE	17.8%	6.5%	(29.1%)	(36.6%)	(64.2%)
Total current liabilities	1,114	1,577	1,450	956	1,274	ROCE	16.5%	6.7%	(20.7%)	(25.5%)	(35.1%)
Long-term debt	85	59	6	5	4						
Other liabilities	0	0	5	4	4						
Total Liabilities	1,221	1,661	1,486	991	1,308						
Shareholder's equity	1,784	1,774	1,323	913	469						
BVPS (Rmb)	1.10	1.16	0.79	0.54	0.27						

Source: Company reports and J.P. Morgan estimates.

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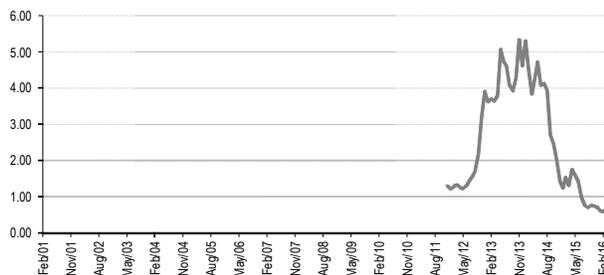
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**JPM Q-Profile**  
SPT Energy Group, Inc. (CHINA / Energy)  
As Of: 11-Mar-2016

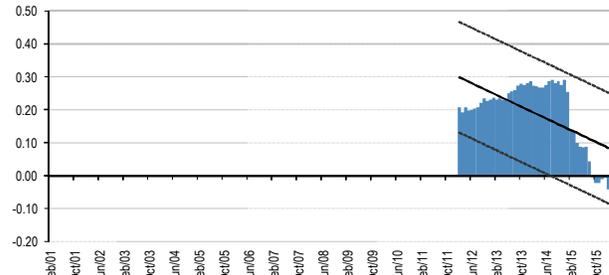
**Global Equity Quantitative Analysis**

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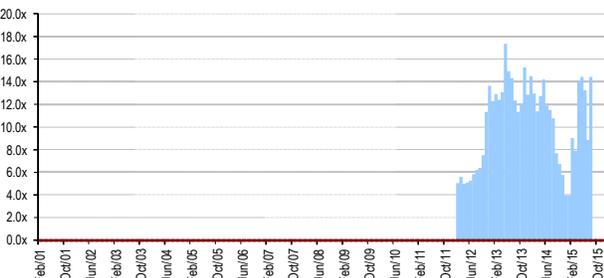
**Local Share Price** Current: **0.64**



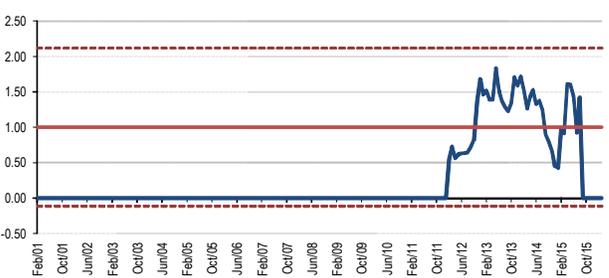
**12 Mth Forward EPS** Current: **-0.05**



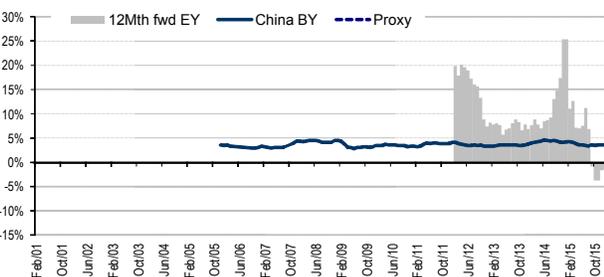
**PE (1Yr Forward)** Current: **0.0x**



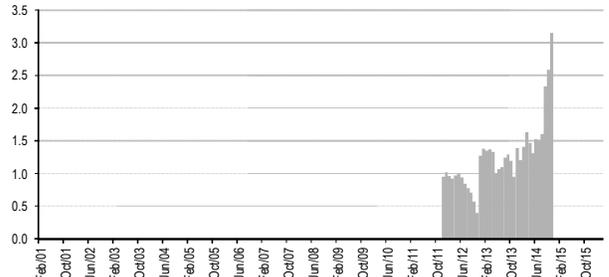
**P/E Relative to China Index** Current: **0.00**



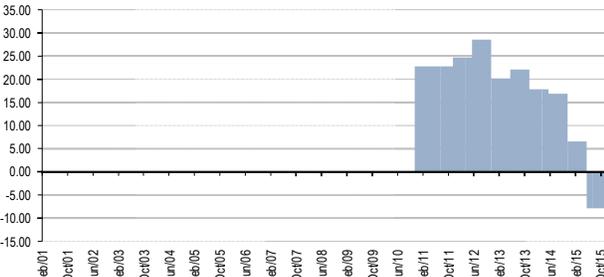
**Earnings Yield (& Local Bond Yield)** Current: **-9.41%**



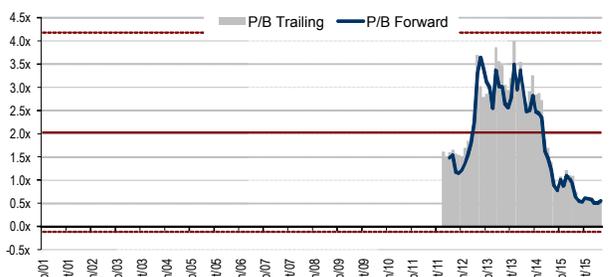
**Dividend Yield (Trailing)** Current: **0.00**



**ROE (Trailing)** Current: **-9.82**



**Price/Book (Value)** Current: **0.5x**



**Summary**

SPT Energy Group, Inc.		TICKER 1251 HK		As Of: 11-Mar-16							
CHINA				Local Price: 0.64							
Energy				EPS: -0.05							
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg
12mth Forward PE	0.00x				2.03	4.18	-0.12	-7%	674%	243%	292%
P/BV (Trailing)	0.52x	0.48	4.00	1.77	0.88	2.35	-0.59				
Dividend Yield (Trailing)	0.00	0.00	3.16	0.97	15.83	39.26	-7.60	0%	390%	306%	261%
ROE (Trailing)	-9.82	-9.82	28.52	20.20							

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

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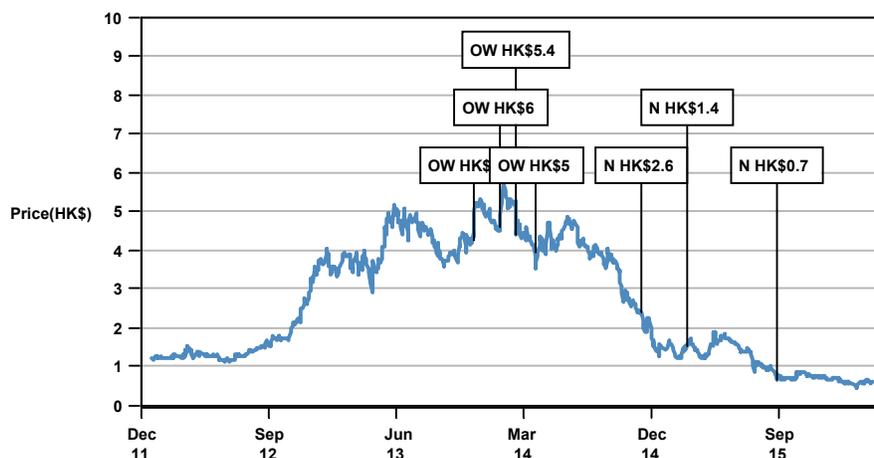
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SPT Energy Group Inc. (1251.HK, 1251 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
13-Nov-13	OW	4.26	5.60
08-Jan-14	OW	4.59	6.00
13-Feb-14	OW	4.42	5.40
27-Mar-14	OW	3.96	5.00
09-Nov-14	N	2.39	2.60
15-Feb-15	N	1.56	1.40
26-Aug-15	N	0.66	0.70

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Nov 13, 2013.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

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