Daily comment

Tuesday 15 April 2014

President Energy, Thales, GKN, technology – Windows Phone 8.1

President Energy PPC:LN 33.5p Mkt cap £132m Analyst: Will Forbes

Will Forbes has published an update, *Time to drill*, in which he discusses the potential of the key Jacaranda prospect in Paraguay. The share price – at 33p – is currently sitting at the lower end of its recent trading range. Drilling is scheduled to begin at the end of May and results will be published towards the middle of August. **Our RENAV is 80p per share**.

The key points of the update are:

The investment case rests on the exploration potential in Paraguay, where the company plans to drill three wells in 2014, starting with the Jacaranda prospect, estimated to contain gross 624mmboe (pMean). Due to the good fiscal terms in Paraguay, even relatively small discoveries would be material for President, but we model that a representative discovery of 120mmbbls would be worth around $16/bbl. An initial CPR by RPS covering three prospects has detailed gross unrisked pMean resources of over 1bnboe. With an inventory of 25 structural prospects and leads, the potential for major value accretion is significant if hydrocarbons are proved.

PPC recently announced details of a rig contract with large Brazilian drillers Queiroz Galvão Óleo e Gás (QGOG) for its 2014 Paraguayan campaign. QGOG will join Schlumberger on the project and brings considerable experience, having drilled with Shell and Petrobras. The rig will be able to drill the deepest of PPC's targets. This contract should serve as notice to investors of the proximity of the 2014 campaign and the game-changing potential nature of that drilling.

The Paraguayan discoveries would be very valuable if confirmed. We model that a 120mmboe oil/gas field would be worth around $16/bbl – gas would still be commercial. These values are lower than consultant RPS's estimates of $25/bbl for a 50mmboe field, mainly due to our commodity price and discount rate assumptions. **Importantly, a discovery of even a small field would be commercial. The 2014 programme is due to start with the Jacaranda prospect, which could de-risk a large swathe of prospects across the acreage.**

Due to the materiality of the Paraguayan assets, PPC's US and Argentinian assets have taken a back seat, but they contribute to a core NAV of 11p/share, with future upside in Argentina notable in the longer term. However, the bulk of our 80p/share RENAV is made up of speculative drilling value, where we attribute 68p/share value to the three prospects targeted. This value is indicative at this stage; success could see multiples of this value realised, while failure could see a fall towards core NAV.

Thales HO:FP €45 Mkt cap €9.27bn Analyst: Sash Tusa

Uncomfortable truths from the capital markets day

The company's discussion of its upcoming performance programme, Ambition 10, and the medium-term financial guidance that drops out of this, clearly came as a material disappointment to some. In addition, we believe there is an emerging risk that Thales deploys much of its cash on acquisitions that are either "strategic", but have little or no visible impact on the company's financials (eg the announced $400m deal for LiveTV), or come with complex governance issues (eg Ansaldo STS, where there could be Italian political sensitivity to a full takeover).

Thales' reported numbers are likely to be significantly affected from 2014 onwards by the company's adoption of IFRS 10/11. We note its decision to account for its 35% stake in DCNS at EBIT in 'other', rather than below the line in 'associates', inflates EBIT, and hence, reported margins. Stripping this effect out (roughly €100m pa), Thales looks only fairly valued on EV/Sales, relative margins and EV/EBITDA terms relative to its peer defence primes.

In the medium term, we believe Thales needs to strongly demonstrate that the rebound in order intake in Q413 was not a one-off, and it can therefore break out of the flat orders/flat sales cycle that has dominated results since 2008 (since when revenues have remained in a c €13bn range, ex DCNS).

We note that, excluding the two notable 'jumbo' orders in 2010-11, Thales' book to bill has remained at c 1.0x over that period.

The most immediate read-across is to to Finmeccanica and Ansaldo STS. **The biggest near-term event risk is what we view as an emerging probability that Thales will bid for Finmeccanica's 40% shareholding (and control) of Ansaldo STS, the rail signalling company**. Thales' CEO and CFO both explicitly ruled out bidding for Ansaldo Breda, the structurally loss-making rolling stock business, but would not rule out bidding for Ansaldo STS. We were struck by the degree to which Thales' criteria for acquisitions (should be civil, global, and strengthen existing Thales businesses) fits Ansaldo STS perfectly. And Thales' CEO's assessment of when he may accept a minority stake (an analysis of "restricted" markets vs "the free world") in our view matches the reality of the Italian market perfectly.

GKN GKN:LN 382p Mkt cap £6.3bn Analyst: Sash Tusa

GKN Q1 IMS: A strong start to 2014

GKN's Q1 interim management statement (IMS) is positive, and we think it will create upwards pressure on investor expectations and (ultimately) consensus forecasts. The company emphasises the Q1 strength (trading profit +19%, margins up from 7.4% to 8.7%) owes much to the absence of restructuring charges (a £23m hit in Q113). In addition, GKN highlights an unusually strong start to the year for car production, which is expected to slow in H2 as Japanese incentives end. Overall performance is strong, with both Aerospace and Powder Metallurgy overcoming particularly strong FX headwinds (-5% and -7% respectively), while Cylinder Liners and Emitec (sales up 25% Q1 on Q1) show the operational gearing inherent in many of GKN's capital-intensive businesses.

We forecast GKN to produce £630m of trading profit and £560m pre-tax for 2014. In Q1 the company has already delivered 27% and 26% of that respectively, compared to 24% and 25% at the same stage of 2013.

This suggests to us that GKN's guidance at the FY13 stage, which emphasised "challenging" end-markets, and highlighted the impact of dollar weakness, is conservative, and that consensus forecasts could drift upwards towards the H1 results on 29 July.

Technology – Windows Phone 8.1 – Richard Windsor

Microsoft continues to hide its light under a bushel

The reviews of Windows Phone 8.1 are starting to come in and they are pretty positive all round. Those that have lived with the new software for several days are finding the updates have created a significant improvement in the user experience. New features such as Cortana, Action Center, WiFi/Data Sense and the UI (user interface) changes have all been pretty well received. Windows Phone still lacks a lot of apps, but this problem is being addressed, albeit much more slowly than I had hoped. Furthermore, it looks as if a number of Windows Phones are being developed for launch this year. Hence, the summer and autumn should see something like eight new devices launched, all with the updated user experience.

This is exactly the kind of activity that is needed to make the Windows ecosystem a success, but a critical piece is still missing. User awareness of Windows Phone and the ecosystem remains almost non-existent, and until Microsoft educates the users, many of these improvements will go unnoticed. The majority of Windows Phone devices seen in retail outlets, which potential buyers get to play with, have no data on them. This effectively means they have no real idea of what it will be like to live their digital lives with Windows Phone. iPhone and Android are brands in their own right but Windows Phone does not have this luxury, and so it must tell everyone explicitly why it is great.

Microsoft's marketing to date has been focused on announcing the presence of Windows 8, but has yet to explain to anyone why they should buy it. Until this changes, market share is going to remain far below its potential, and the good work of its device and software engineers will go unnoticed. It is encouraging to see improvements at the product end but now the message must be spread far and wide. I am still hopeful that Microsoft can make a real go of its ecosystem, as investments in products should logically be matched with investments in marketing. Microsoft has vast resources and I hope it is aware of the shortcomings in its message.

Microsoft, Yahoo! and Google are my favoured ways to look at the mobile ecosystem.

Best regards,
Jeremy Silewicz

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