EDISON

Medserv

FY17 results

Internationalisation underpins growth

Industrial support services

Medserv's strategy to expand its geographic reach and range of services is bearing fruit. FY17 was affected by lower than expected demand and project delays, but Q118 results show strong progress and the order backlog underpins future revenue performance. A change of management and key shareholders at an early stage to source a strategic purchaser have also been announced. We reduce our FY18 estimates on the lower run rate out of FY17 and introduce FY19 estimates.

Year end	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/16	32.8	(1.3)	(2.1)	0.0	N/A	N/A
12/17	28.8	(3.6)	(5.6)	0.0	N/A	N/A
12/18e	36.0	(1.4)	(1.4)	2.0	N/A	1.8
12/19e	39.3	2.2	4.7	2.0	23.4	1.8

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

FY17 affected by demand but Q118 shows progress

Reported FY17 revenues of €28.78m (FY16 €32.82m) were slightly up against our estimate of €28.2m. However, a slowdown in end-market demand and drilling delays prompted the company to lower expectations as the year progressed. Tougher trading conditions than expected also affected profitability, with company reported adjusted EBITDA down at €4.43m (FY16 €5.40m). The reported regulatory EPS loss of 13.8c (FY16 5.9c) and no dividend were as expected. Q118 revenues of €8.3m (Q117 €7.0m) indicated a strong bounceback at Integrated Logistic Support Services (ILSS) (up 75% on Q117), although Oil Country Tubular Goods (OCTG) had a slightly weaker start (down 20% on Q117). Overall, we believe recent wins building the current order book support FY18 expectations of group revenue of €36.7m and group EBITDA of €6.8m.

Expanding services and geographic footprint

The METS acquisition in 2016 broadened the group's service portfolio to include pipe repair and supply chain management. Recent contract wins have broadened the geographic presence of the ILSS business, including a multi-site contract in Egypt that could also present an opportunity for the OCTG business. Medserv is present in eight countries and current tender activity could expand that further. It is active and profitable in six out of its seven operating bases and the company expects to build on its Q118 performance as the year progresses with further growth in FY19. While a strategic purchaser is being sought for all or part of the majority shareholding, we believe there is no time pressure and the management succession plan has been executed seamlessly.

Valuation: Momentum building

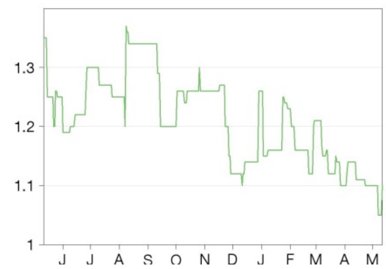
We adjust our FY18 estimates with lower top-line and profitability assumptions and introduce FY19 estimates. The new territories coming on stream support revenue growth for 2018-20 and we forecast financial performance in FY18 to support a dividend. Our DCF-based fair value stands at €1.51 per share, from €1.64 before.

14 May 2018

Price	**€1.10**
Market cap	**€59m**

Net debt (€m) at 31 December 2017	49.2
Shares in issue	53.7m
Free float	35%
Code	MDS
Primary exchange	Malta SE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(3.5)	(5.2)	(18.5)
Rel (local)	(1.9)	(1.3)	(11.3)
52-week high/low		€1.4	€1.1

Business description

Medserv is a Malta-based provider of integrated offshore logistics and services in support of drilling operations in the Mediterranean. The acquisition of the METS companies in February 2016 diversified the company into onshore steel tube stockholding and servicing for countries in the Middle East.

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FY17: A year of transition

Overall, business levels in FY17 were affected by the cost-cutting focus of international oil companies (IOCs), reducing operations and delaying projects. Medserv's trading statement in November 2017 indicated that H217 earnings would be lower than forecast due to delays in both its divisions. Drilling delays at ILSS reduced the FY17 results and contributed to most of the miss. In addition, the OCTG division was subject to movement in demand, where the strong pick-up in activity seen in Iraq in Q3 did not continue into Q4, as the IOCs negotiated next steps.

Exhibit 1: Medserv H117 and FY17 financial summary

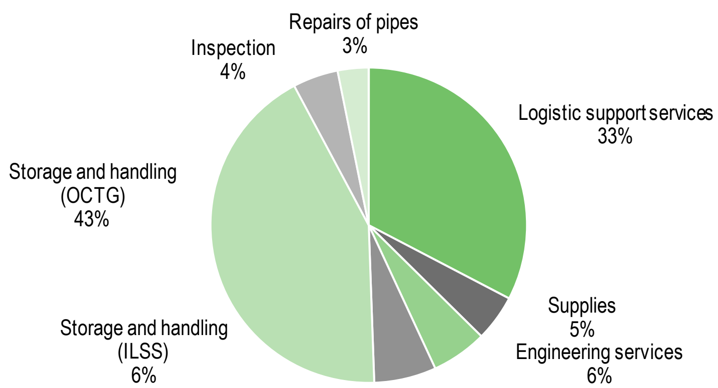
€m	H116	H216	FY16	H117	H217	FY17	FY% change
ILSS	10.6	8.7	19.3	5.8	8.2	14.0	-27%
OCTG	6.5	6.6	13.1	7.6	6.7	14.3	9%
Photovoltaic Farm	0.3	0.2	0.5	0.3	0.2	0.5	9%
Group revenues	17.3	15.5	32.8	13.6	15.2	28.8	-12%
Adj EBITDA (company defined)	3.55	1.9	5.4	1.6	2.7	4.33	-20%
EBITDA	3.43	1.5	4.95	1.39	2.3	3.67	-26%
Operating profit (reported)	1.09	1.1)	0.01	(1.40)	(2.7)	(4.10)	NM
Finance costs	(0.81)	(1.7)	(2.46)	(1.50)	(2.4)	(3.94)	60%
Profit before tax (reported)	0.28	(2.73)	(2.45)	(2.90)	(5.14)	(8.04)	228%
Taxation	(0.06)	5.5	5.43	(0.55)	1.0	0.40	-93%
Net income (reported)	0.22	2.8	2.98	(3.45)	(4.2)	(7.63)	-356%
Net debt	0.16		46.95	47.22		49.21	5%

Source: Company reports

Key figures to note:

- **Reported revenues** of €28.78m (FY16 €32.82m), against our estimate of €28.2m. In April 2017, the company forecast FY17 revenues of €35.94m; however, the slowdown in demand and drilling delays prompted the company to lower expectations as the year progressed. The tougher than expected trading conditions also affected profitability.
- **Company reported adjusted EBITDA** of €4.43m (FY16 €5.40m), against our estimate of €4.2m.
- **Regulatory EPS loss** of 13.8c (FY16 5.9c).
- No dividend.

Exhibit 2: FY17 revenue by major service line



Source: Company reports

ILSS

ILSS reported FY17 revenues of €13.97m, down from €19.25m in FY16. Fundamentally, the division was affected by the cost-cutting focus of IOCs reducing operations and delaying projects.

However, FY18 revenue forecasts in ILSS are supported by growth prospects across a number of geographies.

The key growth driver for the division is Cyprus, where drilling began in Q417. As a reminder, ENI is the leading offshore IOC operating in the Mediterranean and Medserv supports its drilling operations in Cyprus from its onshore bases in Larnaca and Limassol. The Calypso lean gas discovery offshore Cyprus announced by ENI earlier this year is believed to be 'Zohr-like'; Zohr, offshore Egypt, is the largest gas field in the Mediterranean. ENI has a 50% participation in Block 6 where the new find has been made and Medserv's ILSS business recommenced support for the drilling programme in Q417. The new find should provide an extended drilling programme, offering greater visibility and improved returns from Cyprus. To date, Medserv has provided services to ENI from its new Limassol base (full operation) and its storage facility in Larnaca. However, Medserv has taken the decision to consolidate its operations in Cyprus at Limassol. It has also tendered for the provision of services to a second IOC operating in the region, which is at an advanced stage.

Looking forward, Medserv is engaged in advanced negotiations to locate support bases in new geographical regions that should support longer-term growth. The company has indicated that contracts here would be focused on development and production rather than exploration. Medserv announced on 23 January that it had secured business, via a competitive tender, in "a market, considered by the industry to be the big new energy source on Europe's doorstep", which the company now discloses as Egypt. The three-year c €10m contract to provide integrated logistics support services for the production phase of offshore has an option to extend. In the future, Medserv could build OCTG opportunities into the offering in country.

Both ENI and the Egyptian authorities regard the Zohr gas field as a priority for development. The proximity of the field to the Cyprus blocks is a key driver of the renewed drilling activity there. In addition, the expectation that rigs will be prioritised to these programmes has led to the further deferral of the wildcat drilling programme offshore Portugal, where the licence runs to early 2019. Therefore, Portugal is expected to deliver relatively flat performance in the short term. Meanwhile, the company has secured extensions to contracts for offshore Libya. In the region, ENI's strategy for the A and E structures in Bahr Essalam should require increased production support, which should in turn provide a boost to the Malta-base towards the end of the year.

OCTG

OCTG reported FY17 revenues of €14.28m up from €13.08m in FY16. Oman saw a 15% uplift in tonnage supported by the new long-term Sumitomo supply chain contract win in the year. Continuing with the consolidation theme, it is possible the company will consolidate its facilities with the newly opened Duqm in the central Eastern region and Sohar in the North, although this will depend on end-market demand. FY17 was broadly flat for Medserv in the United Arab Emirates, however orders have picked up for the premium threading activity building visibility in this area. Iraq has been impacted by domestic issues and the weakness was visible in Q118. However, the number of land rigs mobilised in country and the current order book suggest activity levels will improve.

While the contribution from Oman is expected to remain stable the UAE should see a small improvement; hence we have made modest adjustments to our estimates for this division. In addition, the company is working hard to secure business in new regions. Medserv has entered a tender for the provision of machine shop services in Uganda, which as a long-term contract could bring greater visibility to the division and predictability to its financial performance.

Photovoltaic Farm (PV)

PV reported FY17 revenues of €0.53m up from €0.49m in FY16. Looking forward, FY18 revenue is expected to remain flat year-on-year.

Outlook

Medserv has reported Q118 revenue and EBITDA performance. FY18 has started strongly for ILSS and although OCTG had a weaker start, we believe the current order book supports FY18 expectations. Medserv is active and profitable in six out of its seven operating bases and expects the company to build on its Q118 performance as the year progresses, with further growth in FY19.

Exhibit 3: Q118 reported and Medserv FY18 estimates for revenue and EBITDA

€m	Q117	Q118	% change	FY17	Medserv's FY18 outlook	% change
ILSS	2.8	4.9	75	14.0	18.4	31
OCTG	4.1	3.3	(20)	14.3	17.8	24
Photovoltaic Farm	0.1	0.1	0	0.5	0.5	0
Group revenues	**7.0**	**8.3**	**19**	**28.8**	**36.7**	**27**
Group EBITDA	0.9	1.40	56	4.4	6.8	55
EBITDA margin (%)	12.9	16.9	31	15.3	18.5	198.8

Source: Company reports

Although FY17 presented a number of challenges to the oil & gas industry, Medserv sees strong projected growth over 2018 to 2020. The business is working tirelessly in each of its divisions to build its geographic presence and deliver technical expertise. Project timing was challenging in Q417; however, the overall direction of travel seen in Q118 and for FY18 remains good. Additional contracts added in Q118 underpin expectations and build addressable markets. Stronger group performance should allow dividend payments to return and we have included this in our forecasts.

The company's FY17 report states "The outlook for the group remains optimistic, as the group anticipates better performance in all its operating segments as the market continues to improve over the year."

Medserv has announced some management changes. Karl Bartolo has been appointed chief executive officer; Karl previously held the role of chief financial officer and has been CEO designate since July 2016. Silvio Camilleri has been appointed chief financial officer after joining Medserv in February 2017 as group financial controller. Anthony Diacono will continue to chair the board of directors; however, Anthony Diacono and executive director Anthony Duncan, beneficial owner of Malampaya Investments, have announced their intention to source a strategic purchaser for all or part for their shareholdings (in total 65.5% of issued share capital). The process is at a very early stage and it is important to note there is no time or financial pressure to sell. In addition, the management succession plan has been carefully thought through.

Estimate revisions, valuation implications

We have revised our estimates for the group and introduced FY19 estimates. As activity increases the operational leverage should allow a rapid recovery in profitability. The increase in drilling programmes and workover projects seen in H217 has provided operational momentum into FY18. In addition, as the company secures business in new geographic markets this will support growth and build visibility for the medium term. We see operating leverage from the improved business activity levels, which in turn should support improved cash generation. We expect improving margin performance as the year progresses, with H218 operations increased drilling activity and greater overhead recovery. However, we have reduced the pace at which this is delivered. As we mentioned earlier, stronger group performance should allow dividend payments to return and we have this in our forecasts, albeit slightly reduced from prior levels to reflect the lower profit contribution.

The group adopted IFRS15 and IFRS16 with its FY17 report. There was limited impact from the IFRS15 introduction. However, IFRS16 adoption prompted a fair value exercise to be carried out for the industrial property rights over the land under the lease agreements, which resulted in a revaluation increase of €16.96m recognised in other comprehensive income. Going forward, we have reduced our property rental cost assumptions to zero while increasing the depreciation charge and other financial costs to reflect the adopted standard.

Exhibit 4: Medserv estimate revisions

Year to December (€m)	2017			2018e			2019e
	Estimated	Reported	% change	Old	New	% change	New
Revenues	28.2	28.8	2	42.3	36.0	(14.8)	39.3
EBITDA	3.4	3.7	8.8	12.5	6.5	(48.3)	10.5
Profit before tax (normalised)	(2.8)	(3.6)		5.8	(1.4)		2.2
EPS - normalised (c)	(6.4)	(5.6)		9.5	(1.4)		4.7
DPS (c)	0.0	0.0		3.8	2.0	(47.4)	2.0
Net debt	46.6	49.2	(5.1)	48.7	54.6	(12.1)	53.2

Source: Edison Investment Research

We continue to employ a capped DCF approach to valuation, which encompasses a six-year explicit forecast projection with a zero growth scenario anticipated in our terminal value calculation. We have used a cost of equity of 11%, which gives us a calculated WACC of 8.2%. Our core assumptions return a DCF value of €1.51 per share, down from €1.64 per share. While our reduced forecasts have affected the valuation, they present upside to the current share price to reflect the growth prospects of the business.

Exhibit 5: Financial summary

€m	2015	2016	2017	2018e	2019e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	42.7	32.8	28.8	36.0	39.3
Cost of Sales	(29.9)	(22.9)	(18.2)	(21.8)	(22.9)
Gross Profit	12.8	9.9	10.6	14.2	16.4
EBITDA	10.3	5.0	3.7	6.5	10.5
Operating Profit (before amort. and except.)	7.6	1.6	(1.2)	1.6	5.4
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0
Exceptionals	(0.1)	(1.2)	(4.501)	(3.2)	(3.1)
Other	(0.2)	0.0	0.0	0.0	0.0
Operating Profit	7.3	0.4	(5.7)	(1.6)	2.3
Net Interest	(1.5)	(2.8)	(2.4)	(3.1)	(3.3)
Profit Before Tax (norm)	6.1	(1.3)	(3.6)	(1.4)	2.2
Profit Before Tax (FRS 3)	5.8	(2.5)	(8.1)	(4.6)	(0.9)
Tax	(1.3)	5.4	0.4	0.5	0.1
Profit After Tax (norm)	4.8	4.1	(3.2)	(1.0)	2.3
Profit After Tax (FRS 3)	4.5	3.0	(7.7)	(4.2)	(0.9)
Average Number of Shares Outstanding (m)	46.1	52.8	53.7	53.7	53.7
EPS - normalised (c)	9.7	(2.1)	(5.6)	(1.4)	4.7
EPS - normalised and fully diluted (c)	9.7	(2.1)	(5.6)	(1.4)	4.7
EPS - (IFRS) (c)	8.9	5.9	(14.0)	(7.3)	(1.2)
Dividend per share (c)	4.3	0.0	0.0	2.0	2.0
Gross Margin (%)	30.1	30.2	36.8	39.5	41.7
EBITDA Margin (%)	24.1	15.3	12.8	18.0	26.7
Operating Margin (before GW and except.) (%)	17.9	4.8	-4.2	4.6	13.8
BALANCE SHEET					
Fixed Assets	24.0	51.4	46.4	44.2	42.1
Intangible Assets	0.0	17.2	14.5	13.2	12.1
Tangible Assets	24.0	34.3	31.9	31.0	30.1
Investments	0.0	0.0	0.0	0.0	0.0
Current Assets	57.1	70.0	106.9	108.6	111.0
Stocks	0.0	1.3	1.2	1.5	1.7
Debtors	12.2	12.8	12.2	14.0	15.3
Cash	1.0	6.2	3.6	2.6	5.6
Other	43.9	49.7	89.8	90.4	88.3
Current Liabilities	(13.3)	(8.3)	(9.4)	(7.7)	(8.3)
Creditors	(9.5)	(7.2)	(7.3)	(7.7)	(8.3)
Short term borrowings	(3.8)	(1.1)	(2.0)	0.0	0.0
Long Term Liabilities	(56.7)	(86.8)	(115.8)	(122.2)	(123.8)
Long term borrowings	(22.4)	(52.1)	(50.8)	(57.2)	(58.9)
Other long term liabilities	(34.3)	(34.7)	(65.0)	(65.0)	(65.0)
Net Assets	11.1	26.4	28.1	22.9	20.9
CASH FLOW					
Operating Cash Flow	10.4	6.0	1.8	(0.5)	8.1
Net Interest	(1.5)	(2.8)	(2.4)	(3.1)	(3.3)
Tax	(1.3)	5.4	0.4	0.5	0.1
Capex	(3.8)	(1.7)	(2.6)	(2.3)	(2.5)
Acquisitions/disposals	(2.6)	(34.5)	0.0	0.0	0.0
Financing	0.5	11.2	0.6	0.0	0.0
Dividends	(2.0)	0.0	0.0	0.0	(1.1)
Net Cash Flow	(0.3)	(21.8)	(2.3)	(5.4)	1.4
Opening net debt/(cash)	24.9	25.2	47.0	49.2	54.6
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(0.0)	0.0	0.0	(0.0)	(0.0)
Closing net debt/(cash)	25.2	47.0	49.2	54.6	53.2

Source: Company reports, Edison Investment Research

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