Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Aban Offshore Ltd.

EQUITY REPORT

May 01, 2014

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Aban Offshore Ltd (AOL) is the largest offshore drilling company in India. The company provides drilling services for offshore exploration and production (E&P) of oil & gas globally. Incorporated in 1986, it made its initial public offering in March 1995. Headquartered in Chennai, the company has operations in eight countries and has a varied client base with players like ONGC, Reliance, Shell, Cairn, Chevron and Petrobas. It forayed into international waters in 2005 with the launch of its subsidiary Aban Singapore Pte Ltd. In 2006 it acquired SInvest, a Norwegian company that helped to bring in eight new jack-ups into its inventory. Apart from drilling and oilfield services, AOL also has a presence in renewable energy with 65MW wind power capacity.

Investor's Rationale

New contracts to drive healthy earnings - Recently, AOL has secured three major contracts which will provide a much needed financial relief to the company. In January 2014, AOL won a contract worth USD 61.3 mn for the deployment of jack-up rig Deep Driller 5 at Offshore Vietnam. It also has bagged a contract worth USD 185 mn from ONGC, in June 2013, for the deployment of drillship, Aban Ice for a period of three years. Besides, it won a contract for deploying jack-up rig Deep Driller 1, in May 2013, which is expected to generate revenue of USD 177 mn. For AOL, it is of paramount importance to improve its fleet utilisation; otherwise, servicing its interest and debt repayment obligations will be a challenge in the medium to long term.

Plans to reduce debt - In order to bring down its debt burden, AOL has recently converted standalone rupee loans of ₹22 bn into foreign currency debt. The foreign loan is at LIBOR plus 6%, which effectively costs at around 6.3-6.5% compared to the earlier rate of 14%. This move will have a very positive impact on AOL as the company will be able to save ~₹1.5 bn annually, which is almost 80% of its FY'13 net profit of ₹1,938.73 mn.

Earnings momentum to sustain, triggers still intact - Recent renewals of contracts at higher day rates and debt refinance are likely to drive healthy momentum in earnings growth. Also, positive outlook on global E&P spending and firm rig rates will help AOL get cyclical uplift for renewal in FY'16. Moreover, positive outcome on US sanction on Iran to further increase ease of operations. Looking at these triggers, we believe, AOL is well placed to earn handsome returns in the coming times.

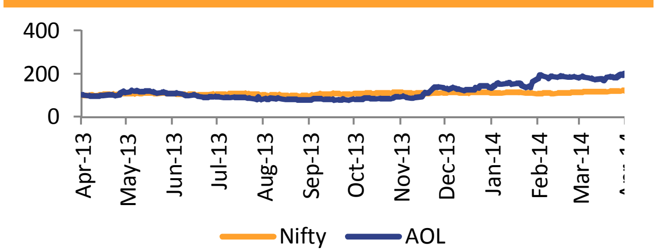
Well focussed on maintaining higher asset utilisation - It is noteworthy that AOL has achieved the principal objective of a near-complete asset deployment in FY'13 and the management seems hopeful to continue enjoying this advantage across the foreseeable future.

Market Data	
Rating	BUY
CMP (₹)	513.8
Target (₹)	610
Potential Upside	~18.7%
Duration	Long Term
Face Value (₹)	2.0
52 week H/L (₹)	574.8/188.3
Adj. all time High (₹)	5,380
Decline from 52WH (%)	10.6
Rise from 52WL (%)	172.9
Beta	0.5
Mkt. Cap (₹bn)	22.4
Enterprise Value	137.4

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹bn)	31.6	36.7	38.9	42.8
EBITDA (₹bn)	18.4	19.9	21.5	23.6
Net Profit (₹bn)	3.2	1.9	2.9	3.9
Adj EPS (₹)	73.9	44.5	67.3	89.4
P/E (x)	7.0	11.5	7.6	5.7
P/BV (x)	0.8	0.7	0.6	0.6
EV/EBITDA (x)	7.4	6.9	6.9	6.6
ROCE (%)	9.4	10.2	9.9	10.3
ROE (%)	11.2	5.9	8.3	10.1

One year Price Chart



Shareholding Pattern	Mar'14	Dec'13	Diff.
Promoters	54.0	54.1	(0.1)
FII	8.2	7.6	0.6
DII	3.9	4.4	(0.5)
Others	33.9	33.9	-

Aban Offshore Ltd - India's largest offshore drilling contractor in the private sector

AOL operates primarily in two business segments, namely, Drilling and Wind Energy.

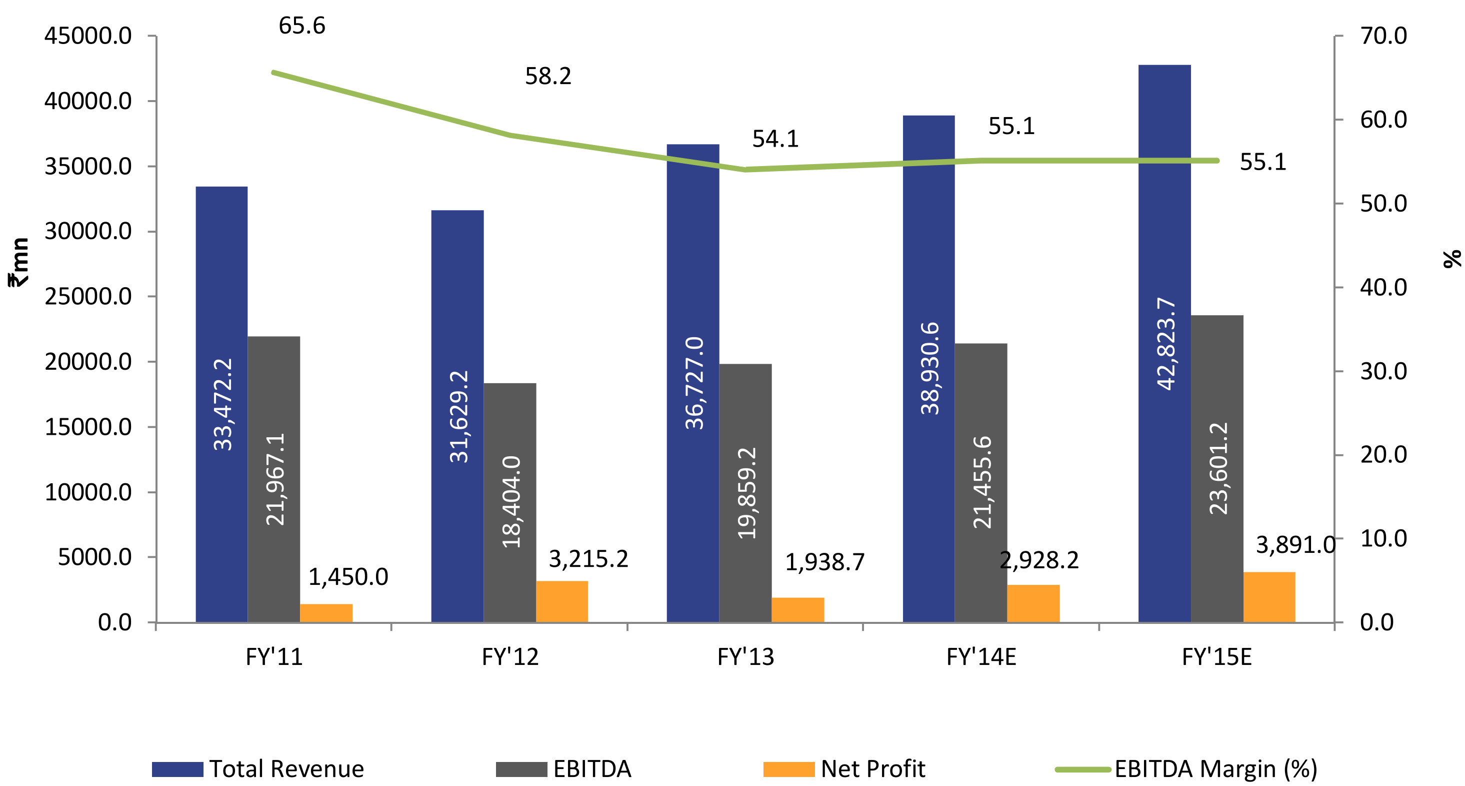
With 15 jack-ups, two drill ships and one floater it is ranked 16th globally in terms of number of rigs owned.

During FY'13, most of the company's rigs were deployed cross long term contracts at attractive rates to progressively de-risk the company from revenue volatility.

AOL, established in 1086, is the country's largest offshore drilling contractor in the private sector offering world-class drilling and oil field services for offshore exploration and production of hydrocarbons to the oil industry in India and abroad. The company operates primarily in two business segments, namely, Drilling and Wind Energy. With 15 jack-ups, two drill ships and one floater, it is ranked 16th globally in terms of number of rigs owned, including all rig types and rigs under construction, and 9th if we consider only jack-up, semi-sub and drill ships, excluding rigs under construction. Apart from drilling and oilfield services, Aban also has a presence in renewable energy with 65MW wind power capacity. The company has a global presence in eight countries and has strong relationship with reputed clients like ONGC, Reliance, Shell, Cairn, Chevron and Petrobas.

During FY'13, the performance for the company was in line with expectation in terms of contracts, revenues and profits. The company witnessed a 14.58% YoY increase in revenues during the year, showing an improvement over the previous year's performance. Moreover, in FY'13, most of the company's rigs were deployed cross long term contracts at attractive rates to progressively de-risk the company from revenue volatility. The company reported an average 80% uptime across its deployed rigs. Additionally, 13 of its rigs reported asset uptime rates of 95% or higher, reflecting higher asset utilisation by the company.

Financial Performance (YoY)



The consolidated net profit surged by 150% YoY to ₹802.8 mn in Q3FY'14, while revenue grew merely by 9.4% YoY to ₹9,943.7 mn during the quarter.

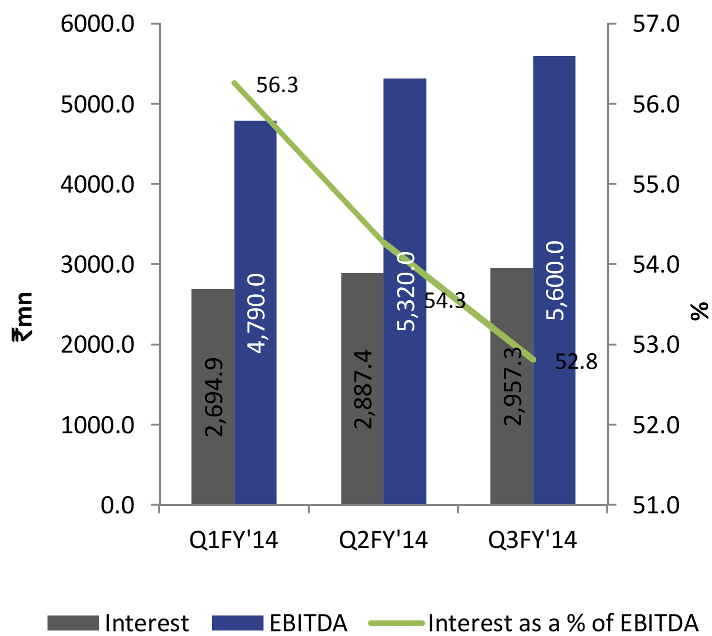
The consolidated EBITDA jumped 15% YoY to ₹5,600 mn against ₹4,877 mn in the corresponding quarter of the previous year with an expansion in EBITDA margin by 280 bps to 56.3%.

Witnessed operationally good performance in Q3FY'14

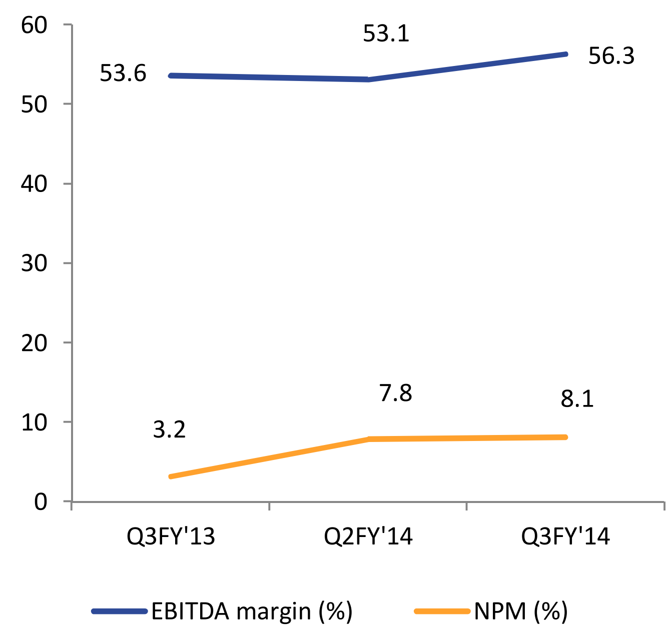
AOL registered healthy performance in Q3FY'14 led by strong asset realization. The consolidated net profit of the company grew impressively by 150% to ₹802.8 mn in Q3FY'14 as against ₹318.0 mn in the same period a year ago, supported by a 64.5% YoY rise in other income to ₹125.1 mn. Revenue for the quarter increased by 9.4% YoY to ₹9,943.7 mn driven by the strong asset realisation along with an increase in revenue from the wind energy business by 42.0% YoY to ₹12.6 mn. Revenue from the drilling business grew merely by 9.4% YoY to ₹9,931.2 mn in Q3FY'14. On the operational front, the company performed quite well in Q3FY'14, as the consolidated EBITDA jumped 15% YoY to ₹5,600 mn against ₹4,877 mn in the corresponding quarter of the previous year with an expansion in EBITDA margin by 280 bps to 56.3%. This was mainly due to a huge decline in rental charges for machinery by 62.2% YoY to ₹84.4 mn along with a decline in insurance cost by 13.7% YoY to ₹413.4 mn.

With a considerable improvement in the operational performance and increasing asset utilisation, we believe the cloud of uncertainty over debt refinancing has reduced and the company will witness a better performance in Q4FY'14 and FY'14 as a whole.

Trends in interest expense as a percentage of EBITDA



Quarterly margins trend



During FY'13, AOL reported an average 80% uptime across its deployed rigs.

Asset realisation continues to remain higher

The company is well focussed on maintaining high asset utilization, which is one of the most crucial determinants of success in the business of rig chartering. During FY'13, AOL reported an average 80% uptime across its deployed rigs. Thirteen of the company's rigs reported asset uptime rates of 95% or higher, a vindication of its longstanding culture of rigorous discipline, continuous training, and better management. Talking about deployment records, the company is well focussed on deploying most of its assets for maximizing the revenue-earning potential and minimizing asset-idling. Most of the company's rigs were deployed across long-term contracts at attractive rates to progressively de-risk AOL from instability in revenue. 16 of its

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rigs were deployed under long-term contracts in FY'13. It is noteworthy that AOL has achieved the principal objective of a near-complete asset deployment in FY'13 and the management seems hopeful to continue enjoying this advantage across the foreseeable future.

Thus, AOL has created a strong base for attractive and sustainable revenue visibility. Looking at the developments as specified, we believe that the company is well placed to take advantage of its healthy asset base and consequently will aid to the revenue growth.

Going forward, better operational performance expected

Refinancing the rupee loan with foreign debt at lower costs and improved asset utilisation will contribute to higher EBITDA margins and profitability going forward.

As per the company's management, the demand environment for the oil and gas rigs is improving. In such a scenario, DD6, DD8, Aban 8, etc, which are due for renewal in FY'15, are likely to be re-contracted at higher charter rates. This could lead to the upgradation of earnings estimates. The issue of 0.4 crore convertible warrants to the promoters reflects the confidence of the promoter in the operational performance of the company. Refinancing the rupee loan with foreign debt at lower costs and improved asset utilisation will contribute to higher EBITDA margins and profitability going forward.

US Iran deal – a key positive development for AOL

Following the US-Iran deal, AOL would be able to get access to low-cost funds from the US and Europe helping it to lower its costs and manage its debt better.

The US-Iran nuclear deal has raised hopes of a recovery in exploration in West Asia. For AOL, the event has come as a key positive development; given its high exposure to the Iran market (Iran contributes ~40% to the total revenue). The company has a total of 18 rigs of which 7 are in Iran as Iran is the fourth largest holder of oil reserves in the world. AOL, which earns about 40% of its revenue from rigs leased to Iranian drillers, can now also renew contracts and improve operating margins that fell to a six-year low in the 12 months ended March 2013. Following the deal, AOL would also be able to get access to low-cost funds from the US and Europe helping it to lower its costs and manage its debt better.

We believe that the company will be able to obtain cheaper US and European financing following the easing of some sanctions on Iran, the company's biggest market. Now, AOL will be able to cut its cost of debt by as much as 2.5% as the easing of sanctions allows it to borrow from European and US banks, a route previously closed. We expect a rise in the company's valuation and there are possibly more gains for the stock in the near term.

Trying harder to reduce the debt burden

On the basis of earnings, the valuations may look attractive, but given the huge debt burden it is prudent to value the company along with debt.

AOL has a debt of ₹113,613.6 mn as at the end of FY'13, which is almost three times its equity and also three times its operating profit. This is the reason that almost 60% of its operating profit is used in servicing the interest cost and thus, this has huge impact on profitability and valuations. On the basis of earnings, the valuations may look attractive, but given the huge debt burden it is prudent to value the company along with debt.

The company, however, is trying harder to bring down the interest cost. It has recently converted standalone rupee loans of ₹22 bn into foreign currency debt. The foreign loan is at LIBOR plus 6%, which effectively cost at around 6.3-6.5% compared to the earlier rate of 14%. This move will have a very positive impact on AOL as the company will be able to save ~₹1.5 bn annually, which is almost 80% of its FY'13 net profit of ₹1,938.7 mn.

During FY'13, AOL reported a 16.1% increase in revenues at ₹36,727.0 mn while PAT declined 39.7% YoY to ₹1,938.7 mn.

Eyes ~33% growth in PAT in FY'15; future prospects seems brighter

During FY'13, the performance of the company was in line with the expectations in terms of contracts, revenues as well as profits. AOL reported a 16.1% increase in revenues at ₹36,727.0 mn while PAT declined 39.7% YoY to ₹1,938.7 mn. Segment-wise also, the company showcased a healthy performance as described below:

Drilling Division: Revenue generated from drilling increased to ₹36,913.9 mn in FY'13 compared with ₹32,228.1 mn in the previous year. As on 31st March 2013, 17 rigs were operational, forecasting lucrative returns in the coming financial year.

Wind energy division: Revenue from the company's wind energy division increased to ₹79.8 mn in FY'13 compared with ₹58.8 mn in FY'12. Further, 28.16 mn units of power were generated in FY'13 compared with 21.37 mn units of power in FY'12.

Continuing the trend, we expect the revenue and PAT to grow by ~10% and ~33% in FY'15 respectively, which reflects the brightest prospects for AOL in the time to come.

Global 2013 E&P Spending Outlook, global exploration and production spending is set to reach a record USD 644 bn in 2013 as against USD 604 bn in 2012, as per Barclays' Global 2013 E&P Spending Outlook.

Positive outlook on global E&P spending to help AOL cut its debt exposure

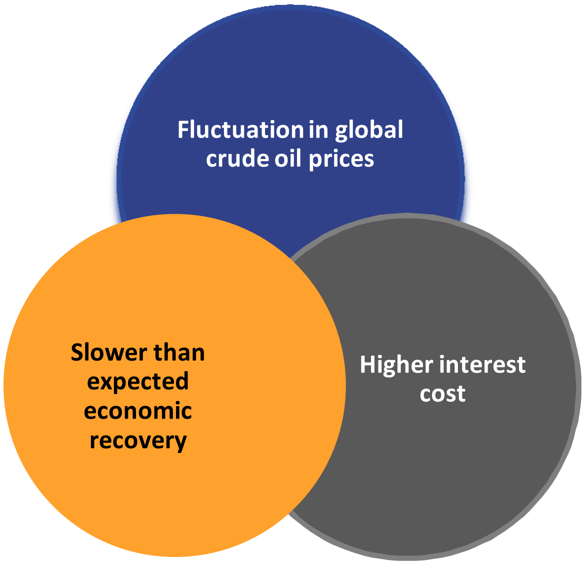
As per Barclays' Global 2013 E&P Spending Outlook, global exploration and production spending is set to reach a record USD 644 bn in 2013 as against USD 604 bn in 2012, up by 7%. Spending growth in 2013 will be driven almost entirely by international markets where estimated capital budgets will jump 9% as the international and offshore cycles continue to build momentum and commodity prices remain at attractive levels.

Year-on-Year Growth in Global E&P Spendings – a key advantage for AOL

USD mn	2012	2013	% Change
North America			
US Spending	138,718	139,634	0.7%
Canada Spending	44,431	44,696	0.6%
Total North America	**183,149**	**184,330**	**0.6%**
International			
Supermajors	93,844	102,210	8.9%
NorthAmerican Independents	21,192	20,083	-5.2%
Latin America	63,263	72,819	15.1%
India, Asia & Australia	93,318	103,620	11%
Middle East	26,936	29,826	10.7%
Russia	47,109	50,346	6.9%
Europe	45,012	47,670	5.9%
Africa	23,586	24,639	4.55
FSU/CIS	1,063	1,201	13%
Others	5,715	7,213	26.2%
Total International:	**421,038**	**459,627**	**9.2%**
Worldwide spending	**604,186**	**643,957**	**6.6%**

We believe that the elevated levels of global crude oil and the positive E&P spending outlook will help the company gainfully keep its rig assets employed. This will also strengthen the resolution of the company to aggressively cut its debt exposure.

Major areas of concerns for AOL



High interest cost, fluctuation in global crude oil prices and slower than expected economic recovery are the major concerns for the company.

Key Concerns

- Fluctuation in global crude oil prices can impact the company's business. But since the company enjoys robust client relationships, whose business is not impacted by short-term market cycles, there will not be any significant impact on the company's revenue base. The company has engaged 15 of its rigs under long-term contracts and two under short-term but continuous contracts, enabling it to achieve attractive returns.

- The company's operations can be hampered owing to its inability to service debt and/ or interest obligations. However, AOL has taken various steps to mitigate this risk. It has converted a significant portion of its rupee loans into low cost dollar-denominated loans with the objective to save substantial sums in interest outflow every year. Also, the company has approached lending banks and institutions for restructuring its entire loan tenure.

- The economic slowdown could affect oil exploration measures, thus has the potential to hamper the company's profitability. But higher prices and technological innovations have unlocked vast unconventional resources for the company, globally, which has reversed the trend of falling output and altering global energy balances.

Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Equity Capital	87.0	87.0	87.0	87.0
Preference Capital	2,810.0	2,810.0	2,810.0	2,810.0
Share Capital	2,897.0	2,897.0	2,897.0	2,897.0
Reserve and surplus	25,719.4	29,940.2	32,399.2	35,639.1
Minority Interest	0.0	0.1	0.1	0.1
Net Worth	**28,616.5**	**32,837.3**	**35,296.3**	**38,536.2**
Long term borrowings	111,443.7	113,613.6	125,342.4	131,609.5
Deferred tax liabilities (net)	268.6	387.5	451.3	451.3
Long term Provisions	19.1	15.7	18.0	18.0
Short term borrowings	5,570.7	5,041.2	4,572.1	4,572.1
Trade payables	6,410.6	9,116.3	8,401.8	8,821.8
Other current liabilities	20,412.6	20,255.1	28,461.3	28,461.3
Short term provisions	943.0	618.5	577.1	577.1
Capital Employed	**173,684.7**	**181,885.2**	**203,120.2**	**213,047.3**
Fixed assets	157,219.6	164,293.8	181,957.9	188,313.4
Non-current investments	34.1	62.2	62.2	62.2
Long term loans & advances	533.9	86.3	97.8	110.5
Other non-current assets	499.4	105.0	67.1	67.1
Current Assets	15,397.8	17,338.0	20,935.2	24,494.2
Capital Deployed	**173,684.7**	**181,885.2**	**203,120.2**	**213,047.3**

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Revenue from operation	**31,629.2**	**36,727.0**	**38,930.6**	**42,823.7**
Expenses	13,225.0	16,867.8	17,475.0	19,222.5
EBITDA	**18,404.2**	**19,859.2**	**21,455.6**	**23,601.2**
Depreciation	5,160.4	4,909.5	5,550.7	6,050.2
EBIT	**13,243.8**	**14,949.8**	**15,904.9**	**17,550.9**
Interest	9,890.9	11,884.5	11,585.6	11,701.5
Other Income	657.7	266.6	367.9	367.9
PBT	**4,010.6**	**3,331.9**	**4,687.3**	**6,217.4**
Tax	795.4	1,418.2	1,772.8	2,340.1
PAT	**3,215.2**	**1,913.7**	**2,914.5**	**3,877.3**
Share of profit/(loss) in joint Venture	0.0	25.1	13.7	13.7
Net profit	**3,215.19**	**1,938.73**	**2,928.2**	**3,891.0**

Key Ratios (Consolidated)

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	58.2	54.1	55.1	55.1
EBIT Margin (%)	41.9	40.7	40.9	41.0
NPM (%)	10.2	5.3	7.5	9.1
ROCE (%)	9.4	10.2	9.9	10.3
ROE (%)	11.2	5.9	8.3	10.1
Adj EPS (₹)	73.9	44.5	67.3	89.4
P/E (x)	7.0	11.5	7.6	5.7
BVPS (₹)	657.5	754.5	811.0	885.5
P/BVPS (x)	0.8	0.7	0.6	0.6
EV/Operating Income (x)	4.3	3.7	3.8	3.6
EV/EBITDA (x)	7.4	6.9	6.9	6.6

Valuation and view

With an improvement in demand environment for oil and gas rigs, AOL is well placed to take advantage of the opportunity. Recent renewals at higher day rates and debt refinance are likely to drive healthy momentum in earnings growth. Positive outlook on global E&P spending and firm rig rates to help Aban get cyclical uplift for renewal in FY'16. Moreover, positive outcome on US sanction on Iran will further increase ease of operations. Looking at the above mentioned developments, we reiterate our positive stance on the stock.

At a current market price (CMP) of ₹513.8, the stock trades at an EV/EBITDA of 6.9x FY14E and 6.6x FY15E. We recommend 'BUY' with a target price of ₹610, arrived at 89.4x FY15E EPS which implies potential upside of ~18.7% to the CMP from long term (1 year) perspective.

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