Deep Industries: Presented by Vinit Bhat

EV: Rs1,224cr
M.cap: Rs987cr
Share price: Rs308
Trailing EV/EBITDA: 8.3x
Trailing P/E: 15.5x

DEEP Industries Limited

Corporate Overview

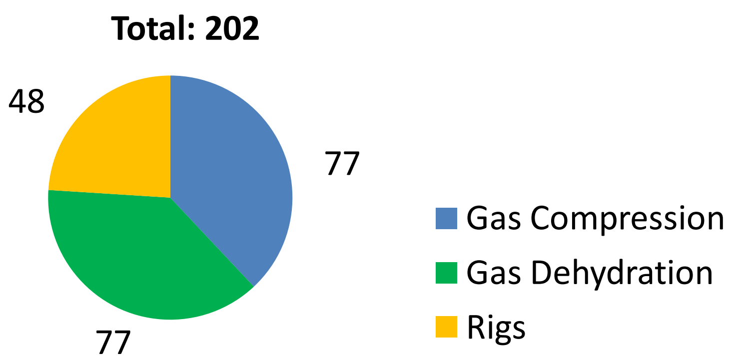
Business Verticals

- A mid stream company in the oil & gas sector, slowly getting into upstream projects
- It has 4 major business verticals :
  - **Gas Compression:** 90% market share in the outsourced natural gas compression market
  - **Gas Dehydration:** A blast in a GAIL pipeline in 2014 forced regulations to make dehydration of piped natural gas compulsory, which the company has taken advantage of and secured contracts from ONGC
  - **Workover & drilling rigs services**
  - **Exploration & Production:** Has a portfolio of 9 blocks, out of which 4 blocks are in the development phase, 1 in appraisal phase and 4 are in the exploration phase. Hydrocarbon **resources of over 1,350 MMBOE**
- Technological tieup with US based Valerus
- Featured in *Forbes Asia - Best Under Billion Dollar Company – 2010 List*

Recent Developments

- Raised **Rs64cr** through a **QIP** at a price of Rs228/share
- PE Tridevi Capital has invested US$20mm (~Rs130cr) for 40% stake in Prabha (subsidiary) for the development of North Karanpura CBM(coal bed methane) block at a **post-transaction value of US$50mm**. Deep owns 51% in this subsidiary and this should start **producing in 2 years**
- **CARE rating upgrade** to A for LT Bank facilities, which should help reduce cost of debt

Revenue Split in 9M FY17 (in Rs. Cr)



Source: Company filings and management guidance

Strong unit economics

Analysis of a single outsourced machine[1] (in Rs. Cr)

Assumed Capex for an individual asset	*100*
Asset Turnover	*0.55*
Life of asset (in yrs)	20
Equity contribution	30
Debt contribution	70
Revenue from Capex	55
Interest Rate	12%

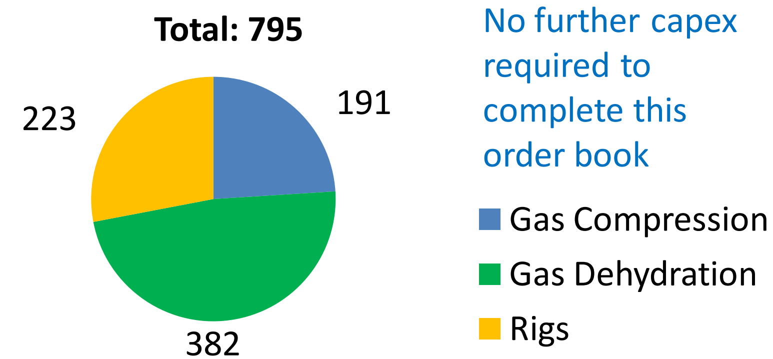
	Year 1	Year 2	Year 3	Year 4	Year 5	
Revenue	55.0	55.0	55.0	55.0	55.0	
EBITDA	30.3	30.3	30.3	30.3	30.3	
PAT	11.8	13.2	14.7	16.4	17.7	
Cash Flow	16.8	18.2	19.7	21.4	22.7	**98.8**
Debt	53.2	35.0	15.3	0.0	0.0	
Net fixed asset	95.0	90.0	85.0	80.0	75.0	
ROCE	18%	19%	20%	21%	22%	

- Assets have a cash payback period of 4-5 years, with a life of 20-25 years
- Low asset turnover, high EBITDA margin is the norm

Portfolio of under development E&P assets[2]

Sr. No	Name of Asset	Participating Interests	Cost Sharing	
1	SR-CBM-2005/III	DIL - 90%	DIL - 90%	
2	GMB Melak Mendung	DIL - 25%	DIL - 20%	Worth Rs166cr
3	NK-CBM-2001/1	PEPL – 25%	PEPL – 25%	
4	SR-ONN-2005/1	DEL – 10%, DIL - 70%	DEL – 10%, DIL – 90%	
5	CB-ONN-2010/3	DEL – 10%	Nil	Rest of the blocks have been allotted no value
6	VN-ONN-2010/1	DEL – 10%	Nil	
7	Kharatar Field	DIL– 66%	DIL – 100%	
8	Bankia Field	DIL– 66%	DIL – 100%	
9	Ghotaru Field	DIL – 66%	DIL – 100%	

Current Order Book (in Rs. Cr)



No further capex required to complete this order book

Note: [1] Life of asset assumed as 20 years, working capital not considered, 55% EBITDA margin considered, ROCE = EBIT(1-t)/Net Assets ; [2] DIL= Deep Industries, DEL= Deep Energy Ltd, PEPL = Prabha Energy

DEEP Industries Limited

High growth with improving ratios

Selected Parameters (in Rs. Cr)

	Mar-13	Mar-14	Mar-15	Mar-16	TTM
P&L:					
Revenue	65.1	90.8	101.3	169.1	257.4
% growth	*7.7%*	*39.5%*	*11.5%*	*67.0%*	*52.2%*
EBITDA	37.8	53.5	56.3	97.0	150.5
EBITDA %	*58.0%*	*59.0%*	*55.6%*	*57.4%*	*58.5%*
PAT	12.1	20.0	21.3	40.9	63.6
PAT %	*18.7%*	*22.1%*	*21.0%*	*24.2%*	*24.7%*
Balance Sheet:					
Net Debt	87.5	111.8	114.1	264.6	
Fixed Assets	172.0	184.5	219.6	253.0	
Cash Flow Statement:					
CFO	32.0	39.0	42.7	70.2	
CFI	(15.7)	(57.7)	(32.2)	(194.1)	
Return Ratios:					
ROE	*7.1%*	*10.9%*	*9.7%*	*16.2%*	
ROCE	*8.2%*	*11.5%*	*10.9%*	*13.8%*	
Asset Turnover	0.26	0.31	0.32	0.36	
Valuation:					
Trailing P/E	8.1	6.2	8.9	10.8	15.2
Trailing EV/EBITDA	4.9	4.4	5.4	7.3	8.0

- EBITDA, asset turnover and ROCE ratios have been consistently improving in the last 5 years
- In spite of having a strong cash flow generating business, the high debt can be attributable to the investments made in the E&P business and the recent capital expenditures for the new orders won
- No visible correlation with oil prices

Family business with high promoter stake

Promoters

Family business run by 3 members of the Savla family – Paras, Rupesh and Dharens

✓High promoter holding in the company

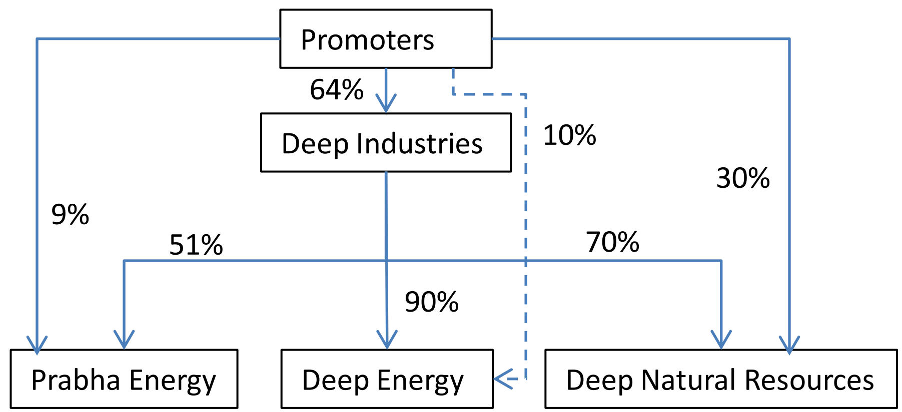
✓Promoter remuneration is not very high

✓Personal assets provided as collateral for few loans

✓As per AR16, the promoters had infused Rs42cr as an unsecured loan to fund capital expenditure

✓Have some loans with HDFC bank, giving some assurance about the asset quality

Company Structure



Advantages of outsourcing services

✓Revenues linked to the gas pipeline are huge for companies. Outsourcing mitigates the operational risk because of the penalty clauses for the contractors

✓Firms prefer sticking to their core competence and would prefer hiring experienced hands

✓Reduced lead time since procurement of equipment takes longer than bids for outsourcing for PSUs

✓No risks of underutilization of equipment and residual value of equipment

Competitive advantages for Deep

✓Most of the machines have reached cash breakeven , thus the company is in a position to bid for lower rates in any new contracts while maintaining returns

✓Higher probability of extending contracts since equipment is already present at the site

✓Strong customer relations with ONGC and Cairn

✓Deep has first movers advantage in the dehydration outsourcing business

✓Replicating technological tie ups will not be easy

Management Guidance and Industry tailwinds

Management guidance

•Maintain EBITDA margins above 55%

•Expect at least 30% growth in FY18, assuming no new contracts are won

•Capex plans of Rs280cr based on expected contract wins , with around Rs100cr in rigs. This will be 70% funded by debt

•Maintain D/E ratio close to 1

•**Cairn order:** Rs36cr gas compression order, which is to be executed in 1 year. There is a provision to extend this contract by 6 months. Capex required is Rs27cr, which will be invested in Q4FY17. The project should need 2-3 years for completion, so there is a high probability of the contract getting renewed

•Business grows in a straight line – no asymmetric growth expectations in profits

•QIP + PE fund infusion ensures that their balance sheet is strong enough to take care of the investments

Industry tailwinds

✓Government plans to **double India's existing oil production** from current 80mmt to about 150-155mmt by 2022

✓Oil minister expects US$20bn invested in natural gas development in the next 5 years

✓**HELP** (Hydrocarbon Exploration Licensing Policy) to encourage O&G sector by relying on revenue sharing mechanism and providing pricing flexibility

✓31 small oil and gas blocks have been recently allotted to firms in NELP, with this trend set to continue

✓Compression machinery of PSU majors is becoming old and the hope is that they will prefer outsourcing it, as per global practices

✓4-5mmscmd worth dehydration contracts to come up for bidding within the next 6 months (currently, Deep has contracts worth 4.1mmscmd)

✓Company expects its gas compression division to grow by 30%

Note: MMT= Million Metric Ton; MMSCMD= Million Metric Standard Cubic Meter per Day

Valuation – Keep it simple

Considerations

✓Internationally, mid-stream firms are valued by DCF of the long term contracts (not applicable here), but they also have a benchmarked EV/EBIDTA of **9x**

✓PEs investing in commodity businesses at a pre-production stage usually **expect an IRR of 35%+**. Thus Prabha can optimistically be valued at Rs303cr in FY19

Comfort in valuation (figures in Rs. cr)

Current Fixed Assets	572
Existing Value of Contracts	437
Value of Prabha subsidiary	166
Other E&P assets	0
Net Debt	(240)
Total Market Cap	**935**

	FY16	FY17E	FY18E	FY19E		
Revenue	169	282	367	535	Capex for FY18	*280*
EBITDA	96	164	205	299	Asset Turnover	*0.6*
EBITDA %	*57%*	*58%*	*56%*	*56%*	Equity contribution	84
PAT	41	71	88	128	Debt contribution	196
PAT %	*24%*	*25%*	*24%*	*24%*	Additional Revenue	168
Current Market Cap	987					
Net Debt		240	392	214	D/E~1 due to QIP+PE infusion	
EV at the current share price		1,227	1,379	1,201		
EV/ EBITDA at the current share price		7.5	6.7	4.0		
Assigned EV/ EBITDA		8.0	7.5	7.0	As opposed to 9x internationally	
Implied EV of services business		1,308	1,540	2,096		
Prabha stake			199	239	Assumed 20% growth on	
Implied Market Cap		1,068	1,347	2,121	Rs166cr in FY17 for Prabha	
Implied Share price		**333**	**420**	**662**		

Worth the risks?

Industry Risks

- **Government capex plans:** Indian O&G sector is extremely reliant on the government for spends. Change in governments/ fiscal issues could change the sectoral outlook overnight
- **Increased competition:** New government policies can lure international players to enter this space. Besides, if the outsourcing of dehydration as a trend continues, deep pocketed Indian firms like L&T can easily enter this market, driving down margins
- Low utilization levels of equipment during the downturn of O&G cycle
- Most of the contracts are short term in nature (below 3 years). Although there is a high possibility of contract extension, the uncertainty still remains and will be a constant overhang unless the industry dynamics change
- Proposed forward integration of ONGC with HPCL could shift the focus of ONGC's management, leading to slower awarding of contracts, along with lesser spends
- The narrative of increased market share of outsourced gas compression/dehydration services might not play out as expected

Company specific Risks

- **Operational risk:** By far the biggest risk. Inability to fulfill contractual obligations can lead to massive fines
- **Client concentration:** ONGC makes up 90% of its order book. This is understandable since ONGC almost runs a monopoly here
- **Asset heavy business**, with a constant need of fresh money to grow the business. Such businesses are prone to even small mistakes in management judgments
- **Currency risk:** Substantial portion of debt is dollar denominated

Promoter Risks – possible red flags

- Company structure incentivizes promoters a lot more than retail investors
- No annual reports for subsidiaries, so cannot be sure of fund diversion through them
- All industry numbers taken from a TechSci report, which was commissioned by the company
- Promoters had 5 criminal cases against them in 2006, with 1 case still going on
- Auditors : Dhirubhai Shah & Doshi. No assurances here

Investment Rationale

Is this a great business? Probably not. Is it a good investment? Definitely worth pondering over

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Industry Tailwind	Stellar order book	Visible growth triggers	Cheap valuation	High promoter holding
• Government focus on natural gas production should open up a lot of opportunities in the outsourcing of essential services like gas compression and dehydration	• High probability of contract extensions	• 9 upstream projects that are yet to start producing, with 1 conservatively valued at Rs166cr. Upstream projects have high IRRs	• Trading at 4x FY19E EV/EBITDA	• Yet to catch the eye of institutional investors