midf RESEARCH

08 August 2016 | Corporate Update

Reach Energy Berhad

Reaching a tipping point

Trading Idea

Fair Value (FV): RM0.98

INVESTMENT HIGHLIGHTS

- **Compelling valuation of assets**
- **Further potential upside from prospects**
- **Stable production with long-term contract**
- **Expect cost savings from infrastructure enhancement**
- **Fair value of RM0.98 based on DCF methodology**

OVERVIEW

Reach Energy Bhd (Reach Energy) has signed an agreement with Palaeontol COOP and Hong Kong-listed MIE Holdings Corporation (MIEH) on March 5, 2016. The agreement is for Reach Energy to obtain a 60% interest in Palaeontol B.V. from MIEH for RM638.2m (USD154.9m). Palaeontol B.V., in turn, controls 100% of Emir-Oil LLP (operator), the owner and operator of 4 production contracts and 1 exploration contract (QA) in Kazakhstan. The assets span across an area of 850.3km².

Compelling valuation of assets. Reach Energy effectively has the rights to 53.5 million barrels of oil equivalents [43.3 million stock tank barrels of oil (MMstb) and 61.4 million standard cubic feet of gas (MMscf)] based on the QA's 2P reserves. Of that, the reserves consist of 81% oil and 19% gas. Based on the consideration, the 2P multiples for the deal works out to 2.9x (or USD2.9 per barrel), which is much lower compared to the recent comparable transactions in Kazakhstan that averaged at 7.3x. Furthermore, Reach Energy is pursuing revenue-generating assets that will contribute positively to its cashflow upon completion of the deal. The asset is at its early stage of production. It does not have to commit to high capex in 2017 as the production infrastructure has already been invested by the vendor.

Further upside potential from prospective reserves. Emir-Oil has yielded positive results during the initial testing phase for its first exploration well located in the Aidai block. In a June update, the operator was studying the use of large scale fracturing and horizontal well technology to increase the well productivity in order to prepare for the development of the field. The exercise confirmed the presence of oil and gas in the Triassic formation. The findings are new proven resources that were not calculated in the current reserve report, which could provide upside potential. Its un-risked prospective resources, estimated at 222.9 million barrels (MMbbl), will be a bonus.

RETURN STATS	
Price (5 August 2016)	RM0.68
Fair Value	RM0.98
Expected Share Price Return	+44.0%
Expected Dividend Yield	-
Expected Total Return	+44.0%

STOCK INFO	
KLCI	1,664.04
Bursa / Bloomberg	5256/ REB MK
Board / Sector	Main/ SPAC
Syariah Compliant	Yes
Issued shares (m)	1,277.82
Par Value (RM)	0.01
Market cap. (RM'm)	868.92
Price over NA	31.73
52-wk price Range	RM0.59-RM0.69
Beta (against KLCI)	0.40
3-mth Avg Daily Vol	1.27m
3-mth Avg Daily Value	RM0.87m
Major Shareholders (%)	
Reach Energy Energy Holding	20.00
PAG Holdings Ltd	8.68
Lembaga Tabung Haji	7.90
JV Swasta Sdn Bhd	3.75

Stable production with long-term contract. The 60% interest in Emir-Oil will make Reach Energy the major shareholder, giving it control over the operatorship. Production has been growing steadily from 2012 to 2014, while the slowdown in 2015 was intentional due to low oil prices (*See Appendix 1*). The operator is lifting approximately 6,000 barrels of oil per day and will build up the capacity gradually. It produces light and sweet crude oil with API gravity ranging from 36-55 degrees. The operator will have the rights to produce until 2036 at three out of the four fields, namely: Kariman, Dolinnoe and Aksaz. Emir Field's contract period ends in 2030. Of these fields, Aksaz is a gas field rich in condensate with condensate gas ratio from 66 to 185 barrel per MMscf. On the other hand, its exploration contract will end in 2017.

Expect cost savings from infrastructure enhancement. Upgrades of the production facility are on-going to increase oil capacity from 6,458 barrels of oil per day (bopd) to 12,000 bopd under Phase 1 and 23,000 bopd under Phase 2. Phase 1 is scheduled for completion by end-2016 while Phase 2 is slated for construction in 2019. As it is, most of the oil and gas produced are being trucked to the Mangyshlak Processing Station. After the completion of phase 1, a 25km oil pipeline and 35km gas pipeline will be construction to be connected to the new central processing facility and then to the state-owned trunk pipelines. The pipelines, which are expected to be completed in 2018, could cut transportation cost by USD4 per barrel from the current USD12 per barrel. The increased capacity as a result of the upgrades will also enhance its output and scale. General and administrative cost is at USD1.5 per barrel now and once production ramps up, it could be reduced to USD1 per barrel. Receivables from the operations are in US Dollars (USD) and payables in Kazakhstani Tenge (KZT), which is an advantage to the operations.

RISKS

Oil price volatility. Crude oil price seems to have found the floor at above USD40 per barrel after dipping below USD30 per barrel earlier this year. That said, the oil price movement is still subject to a lot of events that could affect supply and demand. The International Monetary Fund has reduced its 2016 global economy forecast from 3.2% to 3.1% following Britain's vote to leave the European Union. The projection of world economic growth next year is 3.4%. Based on the relatively muted global growth, the demand for fuels including crude oil, might remain subdue in the near term.

Foreign exchange risks. A stronger USD is positive for Reach Energy but all eyes are on the Federal Reserve for its decision on interest rates. The global uncertainty has led to the Fed taking a cautious stance in its decision on the monetary policy. Another factor that could affect the USD strength is the US presidential election that will take place in November 2016.

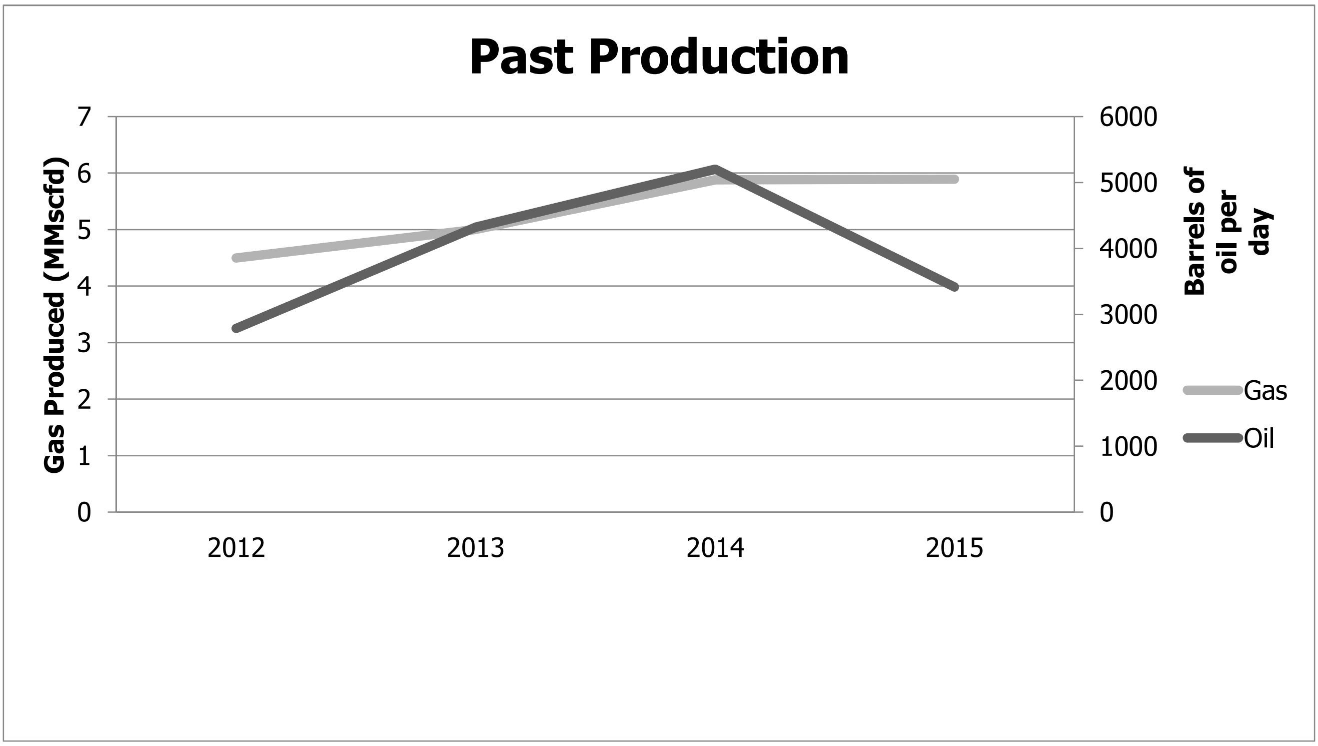
Execution and production risks. The operations of an early stage production asset can be subject to execution and production risks. Execution risks include unexpected drilling conditions, accidents and equipment failure. Production risks due to delays in getting regulatory approvals, insufficient storage or malfunction of the production system may hit the operator's income. Reach Energy has obtained the green light from the relevant regulators in Kazakhstan and Hong Kong and has submitted the proposal to Malaysia's Securities Commission for approval. The deal is also subject to Reach Energy's shareholders' approval.

Incorrect estimation of reserve and resources will dampen Reach Energy's upside potential of the assets. Discrepancy between the assumptions of the reserve estimates and actual production could arise from any misinterpretation of data. A steep shortfall in resources estimates could mean that the valuation of the assets is higher than expected. A much lower-than-expected reserve projection could also lead to lower returns.

VALUATION

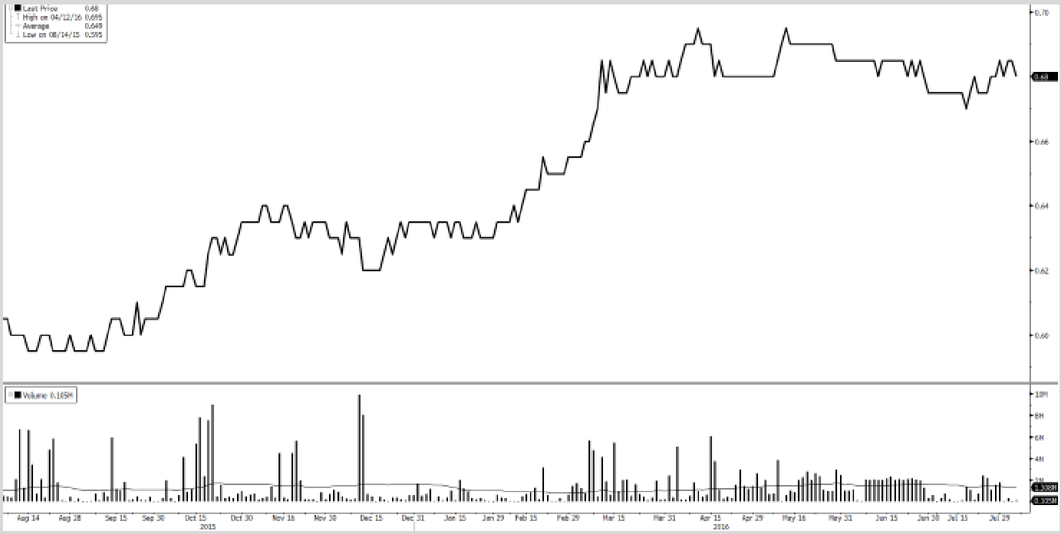
Reach Energy is fairly valued at RM0.98 per share. All in, we are valuing Reach Energy based on the discounted cash flow methodology. Our fair value of RM0.98 assumes a full field lifespan of 20 years (until 2036) based solely on the field's 2P oil reserves. In addition, our prudent valuation only takes into account Phase 1 infrastructure enhancement. Assuming full production after Phase 2 infrastructure enhancement is completed, Reach Energy could be valued up to RM2.31 per share. Our oil price assumption is between USD50-91 per barrel for 2017-2036.

APPENDIX 1



Source: Company, MIDFR

DAILY PRICE CHART



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Source: Bloomberg, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.