

Buying: Petrofac Ltd (PFC)

Price on 1st Mar 2014	Index	Sector
1,368p	FTSE 100	Oil Equipment, Services & Distribution
Market Cap	Revenue	Pre-tax Profit
£4.7 billion	£3.8 billion	£475 million

“Petrofac is a leading provider of oilfield services to the international oil and gas industry. We support our customers to unlock the potential of their assets; on and offshore, new and old.” (www.petrofac.com)

Overview

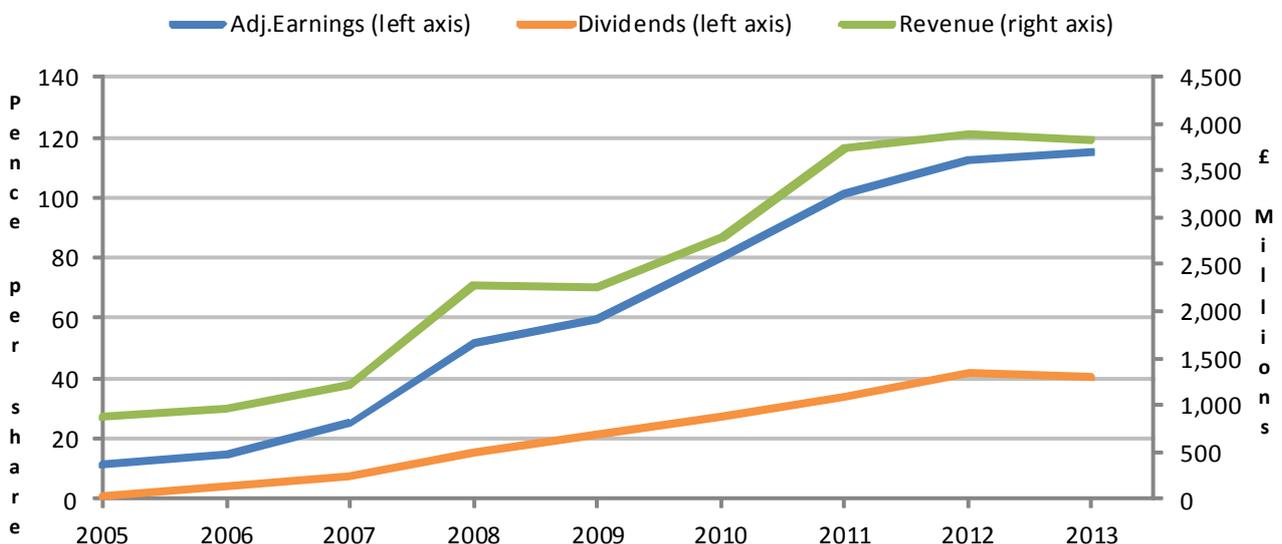
Petrofac is a relatively new company, having started life in 1981 with just 25 members of staff. Since then it has grown very rapidly, listing on the London Stock Exchange with a market cap of around £750 million and continuing to grow to the near £5 billion market cap it carries today.

The key functions of the business are to design and build oil and gas facilities, and to operate, maintain, manage and develop hydrocarbon resource assets on behalf of asset owners. It is involved with training asset owner personnel so they can operate new facilities if and when required, and it also co-invests alongside asset owners in upstream and infrastructure projects.

These functions are carried out through two divisions - ECOM (Engineering, Construction, Operations & Maintenance) and IES (Integrated Energy Services) with revenues and profits split approximately 85% to 15% between the two. ECOM provides a range of stand-alone services to all manner of asset owners, as well as sub-contracting for other oil and gas service providers, while IES provides integrated services through long contracts primarily to state-owned, national oil companies.

10Yr Growth rate	Dividend yield		Valuation (PE10)
35.2%	2.9%		21.6
Growth quality	Debt ratio (max 5)	Pension ratio (max 10)	Rank
93%	0.6	0	23 (out of 236)

Green = Better than FTSE 100, Red = Equal to or worse than FTSE 100



Investment analysis

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality, and that its shares are likely to improve the portfolio in the long-run.

Industrial diversity: Are there less than three companies from this FTSE sector already in the portfolio?

YES Petrofac will be the first company from the Oil Equipment, Services & Distribution sector.

Geographic diversity: Will this company increase the geographic diversity of the portfolio?

YES Petrofac generates just 19% of its revenues from the UK, so it will make the model portfolio more internationally diverse than it currently is.

Operational diversity: Does the company have low dependency risk by not relying on a small number of key customers, suppliers or employees?

YES It has no obvious large dependency risk from customers, suppliers or staff. The IES business is somewhat concentrated on a small number of customers, but there are efforts to diversify the customer base further.

Market strength: Is the company in the leading group within its markets?

YES Petrofac is a global market leader in the provision of engineering, procurement, construction and other services to the oil & gas sector.

Consistent strength: Does the company have a consistent and successful history within the same industry?

YES Although quite a new company, Petrofac has been in the same industry for a long time. The chart on the previous page shows just how successful they have been since listing on the stock exchange in 2005.

Competitive strength: Does the company have any low cost and durable competitive advantages?

NO Although the company has been very successful over many years, there does not appear to be a sustainable competitive advantage. There are some barriers to entry in terms of the scale of expertise and capital required to carry out many of the projects that they bid for, but there is no obvious barrier to stop other companies doing what Petrofac does.

Past problems: Has the company been free of major crises during the last decade? If there were any, were they resolved successfully?

YES There have been no major problems in the last decade.

Current problems: Is the company free of current problems or risks (including excessive debt) which could materially impact its future prosperity?

YES There is no significant crisis surrounding Petrofac. Instead it seems to me that there are (at least) a couple of reasons for the low valuation (low relative to its history of growth and continued expectations for future growth).

First, Petrofac's share price has been more or less flat through 2011, 2012 and 2013 as valuations changed from a PE of almost 17 and a dividend yield of 2.1% to a PE of 11 and a dividend yield of 3%.

A prolonged period of flat share prices removes any "momentum" from the stock, and greedy investors looking for a quick buck will take their demand elsewhere, which can further suppress the share price.

The second - and far more important - reason is the relatively weak fundamental growth the company produced in 2013, and is now expected to produce in 2014. Having grown at double digit rates for many years, 2013 saw revenues, profits and dividends all increase by just a few percent. This current period of weak growth is primarily a consequence of major projects being "rephased" further into the future.

However, the projects have not been cancelled and I don't think cancellation is the most likely outcome. Petrofac still expects these projects to begin sooner rather than very much later, and has reiterated its belief and its goal that it can double 2010 recurring profits by 2015.

Future problems: Is it likely that the company's economic engine will continue to grow and avoid becoming obsolete in the next decade?

YES In the very long-run any company that sticks with the fossil fuel industry is in for a hard time because those fuels will eventually become uneconomic to exploit. However, I think that on any reasonable timescale that investors are likely to care about (perhaps up to a few decades) I cannot see any obvious reason why Petrofac would fail or shrink significantly over that timescale, other than through the sort of unforeseeable risks that all companies are subject to.

For now the world still need vast amounts of oil and gas, and Petrofac seem to be one of the best companies in the world at designing, building, operating and maintaining oil and gas assets and infrastructure.

Therefore my baseline assumption is that it will continue to grow at least as fast as the average company over the medium-term.

Making the trade

I will be adding Petrofac to the model portfolio a few days after this issue is published, with the usual position size of approximately 1/30th of the portfolio's total value.

“If my universe of business possibilities was limited, say, to private companies in Omaha, I would, first, try to assess the long-term economic characteristics of each business; second, assess the quality of the people in charge of running it; and, third, try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town. Why, then, should Berkshire take a different tact when dealing with the larger universe of public companies?”

- Warren Buffett

Higher ranked companies that were not selected	Reason for not investing
Vedanta Resources	Too much debt
FirstGroup	Recent large rights issue means that past “per share” results do not relate well to future “per share” results.
Phoenix IT	Too UK focused and too small
Sainsbury	Already hold 3 Food & Drugs Retailers
Carillion	Already hold 3 Support Services companies
Pennon Group	Debt ratio too high
Smiths News	Already hold 3 Support Services companies

IMPORTANT NOTICE: This investment analysis is for information only. It should not be construed as advice and should not be relied upon before investing. You should perform your own investment analysis and factual verification before making investment decisions. If you need advice you should seek a financial advisor. See the important notes on the last page.