

Depthwise Nigeria Limited

An improving and upgrade story

Summary

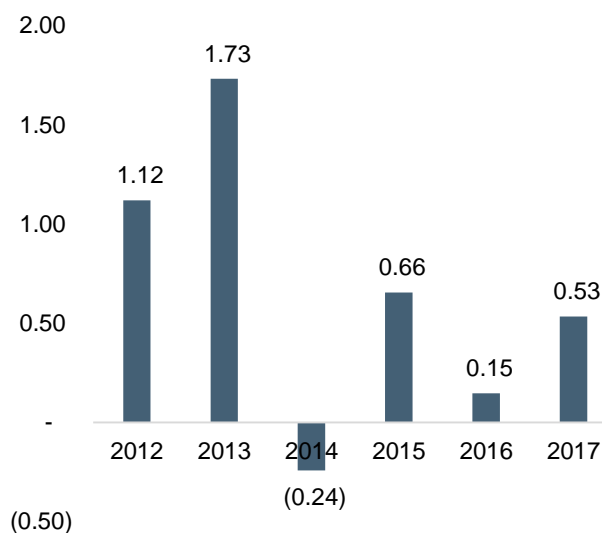
- Depthwise, through its vehicle – Depthwise Funding Company Plc, seeks to raise ₦20 billion via series 1 of its ₦30 billion program. The company intends to use the proceed to finance its maturing commercial syndicated loan and finance ongoing business operations. We believe that Depthwise is an improving credit story driven by both organic growth in earnings and ongoing deleveraging exercises. The proposed refinancing as well as our expectation of higher earnings points to a lower leverage ratio in coming years. Based on our analysis, finance charge is expected to decline by 65% over 2018, reflecting the 5-year moratorium offered by its lessor, Megadrill Service. Farther out, whilst finance charge will track higher on the back of its bond issuance, the expected jump in earnings—given the revival of 2 key rigs - will see coverage ratio expand. We project expansion in interest coverage ratio to 3.0x (2017:1.0x). Furthermore, its improved earnings should translate to higher free cash flow, as management guides to no major capital expenditure in sight. Depthwise is an indigenous oil and gas servicing company, providing marine, drilling, and other related services. The rig business contributes the largest portion of revenue (65%).

- Risk to Outlook.** The company remains sensitive to crude oil prices and volumes, though, its operation in shallow waters, mode of contract, and relative peace in the region, provides a buffer should crude oil prices touch \$40-\$50/bbl. and some stability in cash flows. Elsewhere, despite healthy cashflows, we note the increase in receivables, with a high proportion of it categorized under ‘existing customers with some default in the past’. Also, on the positive side, the planned refinancing of dollar loan to naira sizably moderates its exposure to FX risk. Also, the bond issuance is fully guaranteed by Megadrill Service Ltd – the lessor of the oil rigs to Depthwise Ltd.

Programme

Debt Issuance	₦30 billion
Series 1	₦20 billion
Tenor	4 Years
Due Date	2022
Issue Price	₦1,000
Minimum Subscription	₦10,000,000
Listing/Quotation	FMDQ-OTC
Issue Rating (GCR)	BBB (Stable)

Estimated adjusted FFO/net debt (%)



Source: Company Financials, ARM Research

See page 9 for analyst certification and important disclosures.

ARM Securities has been appointed as joint issuing house on the bond offering. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Investment Highlights

- Depthwise has recorded impressive earnings growth, from a low of ₦439 million in FY 12 to ₦3.4 billion in FY 17, with its shareholder's fund expanding five-fold over the period to ₦12 billion in FY 17 (2016: ₦3.8 billion). Though Debt to equity ratio improved from 11.7x in 2012 to 1.1x in FY 17, leverage ratio ticked up to 4.2x relative to 5-year average of 3.0x, following its \$100 million (₦20 billion) syndicated loan the company got in 2013. To add, its coverage ratio barely matched up in prior year with the EBITDA of ₦3.2 billion being 1.0x interest expense of ₦3.2 billion as at FY 2017.
- Going forward, we expect improved fundamentals. First, earnings are expected to improve sizably on the back of increased activity in the oil industry even as the three oil rigs are now active compared to 2017 when just one was active.
- Elsewhere, we see lower finance cost going forward. This is hinged on the 5-year moratorium offered by its lessor—Megadrill Services Ltd—on both interest and principal payment of the lease obligation in order to relieve the finance cost burden resulting from the planned bond issuance. Furthermore, with about ₦1.1 billion expected as interest payment on the existing debt¹ – syndicated commercial loan of \$100 million, finance cost should therefore decline 65% to ₦1.1 billion in 2018 given that there is a six-month moratorium on the new debt issuance. Beyond 2018, we have assumed a premium of 200bps to FGN bonds on the planned debt issue, which implies a finance cost of ₦3.1 billion² per annum. Thus, we see finance cost declining relative to prior period.
- Based on our estimated funding cost, we expect coverage ratio of 3.0x over 2018 (2017:1.0x) with leverage ratio declining sizably. In addition, we expect the improved earnings to translate to higher free cash flow with no major capital expenditure in sight.

¹ The syndicated loan is being refinanced and interest payment will be made for Jan – Mar 2018, the maturity date.

² The interest payment on the ₦20 billion debt issuance

Figure 1: Movement in total debt and debt/equity

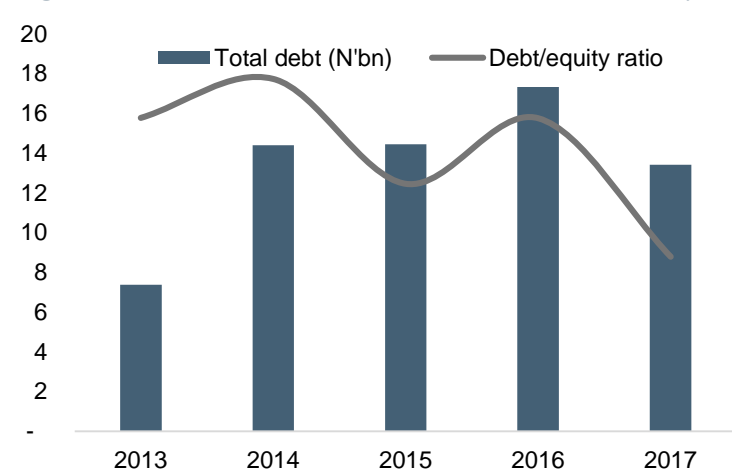
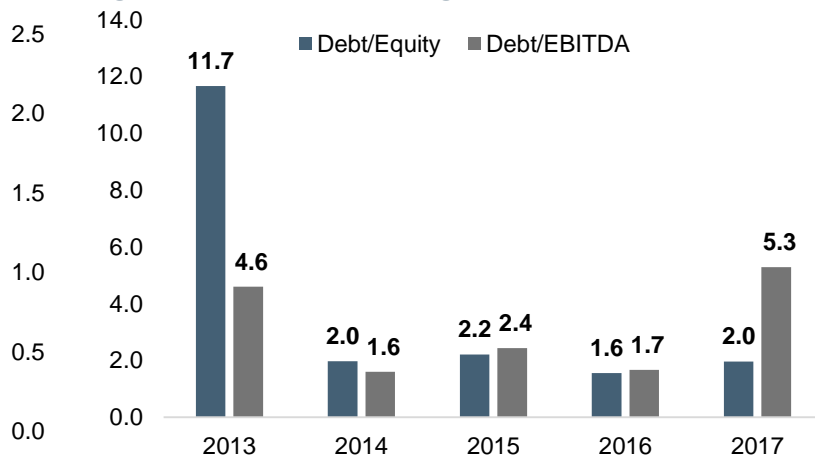


Figure 2: Trend in Leverage ratio



Source: Company Financials, ARM Research

Table 1: Finance cost highlight (₦'000)

	2016A	2017A	2018E	2019F	2020F	2021F
Interest on borrowings	2,137,530	1,698,595	1,132,200	3,100,000	3,100,000	3,100,000
Interest on finance lease	2,657,929	1,512,724	0	0	0	0
Total finance cost	4,795,459	3,211,319	1,132,200	3,100,000	3,100,000	3,100,000

Source: Company Financials, ARM Research

Table 2: Key Ratios of Comparable Companies

Company	Debt/EBITDA (x)	EBITDA Mrgn (%)	EBITDA/Interest Exp (x)	FFO/Total Debt (%)	FFO/Interest Exp (x)	Debt/Equity (%)
CALFRAC WELL SERVICES LTD	3.6	11.8	3.3	10.7	1.2	185.5
GULF INT SERVICES	7.1	26.8	3.4	14.2	4.2	137.9
INDEPENDENT PETROLEUM GROUP	16.8	1.3	1.9	0.0	0.0	150.6
POLARCUS LTD	-	31.1	1.1	-4.7	-0.4	317.1
GEODRILL LTD	0.2	24.5	51.8	256.3	23.6	6.8
BURGAN CO FOR WELL DRILLING	6.9	31.0	4.4	17.2	4.6	157.2
GULF PETROLEUM INVESTMENT	-	14.9	13.2	39.9	5.5	18.4
DEPTHWIZE	4.2	19	1.0	-2.0	-0.1	110
AVERAGE	4.8	21.1	7.7	20.0	2.3	94.9

Source: Bloomberg, ARM Research

Business Overview

- Depthwize is an indigenous oil and gas servicing company, providing marine, drilling, and other related services. In the drilling business segment, the company operates three rigs (Majestic, Imperial, and Monarch). Also, Depthwize has in its fleet four turgo boats and associated newly built badges to support its drilling services. The three rigs are currently active. The company operates majorly in shallow water drilling. The company currently has one contract with Muni Pulo Limited and two contracts with Belbop Nigeria Limited.
- The three oil rigs are on a finance lease from Megadrill Services Ltd. The company entered a finance lease agreement with Megadrill Services Limited for the lease of the Majestic and Imperial rig on March 1, 2012 and January 1, 2013 respectively. The agreement for the newest rig—Monarch was effective on May 1, 2015. The lease period for each rig is 20 years, with interest on the lease rentals payable at an annual rate of 9.5%.
- As at FY 17, the rig business contributed the largest portion of revenue (65%, up from 62% in FY '15), followed by Marine spread revenue which came in at 27% (from 22% in FY '16 and 15% in FY '15). From earnings perspective, rig operation is the largest in the bucket followed by the marine business. Aside staff costs (~30% of total expenses), other major component of the Company's cost is its depreciation cost (~16% of total expenses) and Insurance (~7% of total expenses) cost due to the high capital expenditure structure and riskiness of the business.

Table 3: Fair Value of Rigs owned by Depthwize as at July 2017

Description	Amount
Majestic	\$38,816,000
Imperial	\$17,920,000
Monarch	\$31,529,000
Total	\$88,265,000

Table 4: Contracts Summary

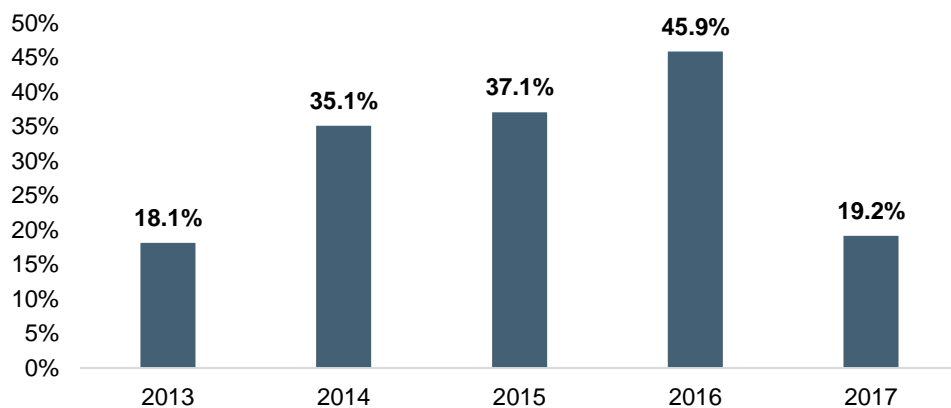
	Imperial Rig	Majestic Rig	Monarch Rig
Contract date	Feb-18	Dec-17	May-18
Duration	Upon completion	3 years	Upon Completion
Renewable	1 year	1 year	1 year
OPL	OPL 231	-	OML 103
Company	Muni Pulo Ltd	Belbop Nigeria Ltd	Belbop Nigeria Ltd

Source: Bond Prospectus, ARM Research

Higher oil price to grease earnings

- Depthwize has remained resilient in the past years despite reduced activities witnessed in the oil and gas industry between 2015 and 2016, as a result of the crash in oil price and incessant pipeline vandalism. As an oil servicing firm with its business linked directly to oil explorers, revenues dipped between 2015 and 2016 at an average of 6.6%. Prior to this period, the company maintained a topline average growth of 47%. However, EBITDA has maintained an upward trajectory over the review period, rising by a CAGR of 60% between FY 12 and FY 17 (-2.0 YoY).
- In 2017, major support to earnings came from interest income (FY 16: ₦285k, FY 17: ₦3.8 billion) of which the management attributed to the modification of the repayment terms on its finance lease obligation. For context, Megadrill Services Ltd, the lessor to DepthWize gave the company a 5-year moratorium in order to relieve the interest payment burden of its planned debt issuance. Accordingly, interest expense also declined by 33% YoY majorly from interest payment on finance lease. Following the recede in finance cost, EBITDA/Interest Expense printed at 1.0x from 0.68x in the previous year.
- Going forward, we see earnings improve sizably. First, improved oil price typically means there will be more exploration activities in the oil industry. In addition, the incessant pipeline vandalism witnessed in the Niger Delta region has reduced drastically which has further boosted production activities. In terms of composition of revenue, we see the rig business retaining its major share even as the three rigs are fully active compared to 2017 when just one rig was active.
- The five-year moratorium given by Megadrill Service will drive finance cost lower over the coming years. With no major capital expenditure in sight, increased EBITDA should translate to improved positive free cash flow.

Figure 3: EBITDA margin trajectory



Source: Company Financials, ARM Research

Key Risk/Catalyst

- One key risk to monitor is the high portion of its receivables (95% of total receivables – ₦16.7 billion) categorized under ‘existing customers with some default in the past’. With the fact that Depthwize is still in business with the client creates further risk.
- Other risks to monitor is the sensitivity of Depthwize business to oil prices and militant activities in the Niger-Delta area considering it operates majorly in shallow water drilling. Lower oil price will cause a reduction of activities in the oil industry, thus limiting the company’s earnings. Also, a blow-out of militant activities like what was witnessed in 2016 could see business operation decline.
- However, we see some mitigating factors. First, the bond issuance is fully guaranteed by Megadrills Service Ltd – the lessor of the oil rigs to Depthwize Ltd. In addition, the planned refinancing of FCY loan to LCY debt creates an opportunity to avert foreign exchange risk.

Table 5: Depthwize – Key Financials and Ratios

Income statement (₦'000)	2012	2013	2014	2015	2016	2017
Revenues	6,496,205	13,095,759	16,362,483	20,773,824	16,672,056	16,527,587
EBITDA	1,176,952	4,595,578	5,900,021	8,667,892	3,276,710	3,214,749
Interest Expense	832,191	1,713,533	3,668,936	6,858,909	4,795,459	3,211,319
Net Income	439,051	3,282,743	2,748,605	2,781,504	(472,575)	3,423,186

Cash flow statement (₦'000)	2012	2013	2014	2015	2016	2017
CF from operating activities	3,884,766	6,737,742	(2,786,701)	9,392,192	2,444,210	7,089,527
CAPEX	13,089,397	10,439,874	932,070	12,781,750	-	-
Free Cash Flow	(9,204,631)	(3,702,132)	(3,718,771)	(3,389,558)	2,444,210	7,089,527
FFO (EBITDA-Int Exp-Tax)	432,146	3,276,759	2,730,018	2,751,892	(472,860)	(329,100)
CF from Inv activities	(13,089,397)	(10,439,874)	(940,958)	(12,786,380)	(9,171)	-
CF from financing activities	11,149,537	5,253,750	3,132,431	596,235	(1,904,183)	(7,572,046)
Net Cash Flow	1,944,906	3,496,524	2,901,296	103,343	634,200	151,681

Balance Sheet (₦'000)	2012	2013	2014	2015	2016	2017
Cash and Equivalents	1,944,906	3,496,524	2,901,296	103,343	634,200	151,681
Total Assets	17,349,228	30,859,090	34,800,962	50,019,024	51,824,055	49,291,465
Total debt	5,417,992	7,385,374	14,397,572	14,441,785	17,337,957	13,423,067
Net debt	3,473,086	3,888,850	11,496,276	14,338,442	16,703,757	13,271,386
Total Liabilities	16,885,177	27,113,366	28,306,633	40,743,191	43,020,797	37,065,021
Equity	464,051	3,745,724	6,494,329	9,275,833	8,803,258	12,226,444

Ratios	2012	2013	2014	2015	2016	2017
Debt/EBITDA (x)	4.6	1.6	2.4	1.7	5.3	4.2
EBITDA Margin	18%	35%	36%	42%	20%	19%
EBITDA/Interest (x)	1.41	2.68	1.61	1.26	0.68	1.00
Total Debt/EBITDA (x)	4.60	1.61	2.44	1.67	5.29	4.18
Debt/capital (x)	1.9	0.8	0.8	0.8	1.4	1.1
Debt/Equity (x)	11.7	2.0	2.2	1.6	2.0	1.1
FFO/Total debt	8%	44%	19%	19%	-3%	-2%
FFO/Interest Exp (x)	0.52	1.91	0.74	0.40	-0.10	-0.10
Asset/Equity ratio (x)	37.4	8.2	5.4	5.4	5.9	4.0

Source: Company Financials, ARM Research

Bond Offering

- The Company is seeking to raise ₦20 billion in a ₦30 billion series program. The company intends to use the proceeds to refinance its maturing commercial syndicated loan and finance ongoing business operations.

Table 6: Use of Proceed

Use of proceed	Amount (N'000)	% of proceed
Refinancing of outstanding	14,103,103	71%
Cash reserve account	1,830,000	9%
Working capital	3,760,485	19%
Cost of issue	306,413	2%
Total	20,000,000	100%

Source: Bond Prospectus, ARM Research

Bond Structure

Issuer	Depthwize Funding Company Plc
Sponsor	Depthwize Nigeria Limited
Guarantor	Megadrill Services Limited
Security	The Bonds issued under the Programme will be secured by an All Assets Debenture by Depthwize Nigeria Limited and a mortgage security over the rigs operated by the Sponsor, provided by Megadrill Services Limited
Status of the Bonds	The proposed Bond will be repaid over three years from a sinking fund to be established by the Issuer on behalf of Bondholders. The Sponsor shall on an annual basis, for as long as the Bond remains outstanding, pay 60% of its reported Free Cash Flow (FCF) to the Issuer for the benefit of the Sinking fund till principal amount is complete.

Source: Bond Prospectus, ARM Research

Company Background

- Depthwize Nigeria Limited was incorporated on 29 July 2011; the registered address of the company is at Block 42, Plot 11A, Rasheed Alaba Williams (Road 13), Lekki phase 1, Lagos state. With the object of the company being to:
 - ✓ To carry on business as contractors for the lease, purchase, and operation of offshore drilling rigs and to carry out all associated marine operations.
 - ✓ To carry on business as contractors in all matters associated with offshore drilling contracts including installing rigs, laying infrastructure, erecting structures, and providing all things necessary petroleum and gas supplies for the oil rigs.
 - ✓ To build, construct, supply, import, export, lease, act as agents for the sale, purchase, and lease of drilling rigs and marine vessels of all kinds.

Ownership

- The authorized share capital of the Company is ₦25,000,000 divided into 25,000,000 ordinary shares of ₦1.00 each.
- The Company is majorly owned by the Chairman, CEO who holds sixty percent shareholding with 15,000,000 ordinary shares while the remaining forty percent (10,000,000 ordinary shares) is held by Dwize LP, a limited partnership. The partners of Dwize LP are Mr. Uche Dimiri and Mr. Olumide Akpata

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