Sizzling global expansion

Integrated oil and gas process equipment manufacturer, KNM Group Bhd, is on an aggressive global expansion plan, spreading its wings to China and the Middle East. TA SECURITIES favours the plan

KNM Group Bhd's order book presently amounts to RM214mil, which will last until mid-2005. Its order book has increased commendably by 42% since listing in August 2003.

The major portion of the projects is recurring from KNM's long- term clients and most of them will be manufactured in Malaysia.

On top of that, the company is bidding for over RM1bil worth of jobs, which are predominantly for exports in the years 2005 and 2006.

Plant expansion to meet rising demand

KNM has four manufacturing plants in Melaka, Gebeng, Bintulu and Changshu, with a combined annual capacity of 28,500 metric tonnes. Due to the robust demand locally and abroad, both the Melaka and Gebeng plants are running at full capacity.

The new Changshu plant in China, which started commercial production in May 2003, is running at 30% utilisation currently.

Potentially, the utilisation of Changshu plant could hit full capacity by next year when new projects come on stream.

In view of the strong demand, the management has planned for an additional annual capacity of 18,000 tonnes, representing an increase of 63% from the present capacity over the next two year.

Exclusive Asian manufacturer for Shell system

KNM has recently been selected as one of the three manufacturers for Shell's twister supersonic system. The system was developed by Shell for its worldwide field development project. The other two players are Dutch companies.

Selection is based on proven reliability and compliance to quality requirement. KNM has completed the first system for Shell worth RM19.8mil in Sarawak.

We believe there is a high potential for KNM to penetrate Shell's platform, especially in the Asia region due to cost efficiency in terms of locality.

Robust opportunity in China

China, as the world second largest oil importer, has voracious appetite for more fuel.

Booming order book

Customer	Project Name	Value (RM mil)
Petronas Group	MLNG Plant, CUF, MCOT, Ammonia & Urea Plant (M)	32.8
Flour Daniel Inc	Long Lake Project (Canada)	32.8
	Enfield Project (Australia)	
	Sapref Lion Project (S.Africa)	
	Gasco Ethane (UAE)	
ExxonMobil Group	Guntong-E, Semongkok-A & Seliga-A (Malaysia)	30.7
Japan Gas Corporation	Sohar Refinery (Oman)	24.3
	LOP Nanhai (China)	
Uhde Gmbh	Fertiliser Complex SAFCO IV (Saudi Arabia)	15.6

Source: KNM

Plant expansion

Plants	Additional Capacity	Target Completion
Melaka	3,000	3Q 2004
Changshu Phase 2	9,000	End 2005
FBM-KNM, Jebel Ali	3,000	End 2004
Batam, Indonesia	3,000	Mid 2005
Total	18,000	

Source: KNM

Crude oil imports rose 31% to a record high of 91million tons last year and is estimated to increase to 100 million tons this year.

Imports may surge to as much as 110 million tons next year and reach 300 million tons by 2020.

The country's oil refining capacity will be straining to keep up with rising demand and efforts have been stepped up to develop the domestic resources.

Some of the major developments include Royal Dutch/Shell's plan to build a refinery with 10 million metric-ton capacity in southern China, petrochemical complex in the southern city of Huizhou, while more plans for gas-fired power plants are underway in Guangdong, Tianjin, Beijing and Shanghai.

KNM, as a cost competitive player with global standard certification from International oil and gas companies, is well-positioned to take advantage of the robust demand in China. As its Korean competitors are running close to full capacity, KNM foresees that its operation in China will achieve full capacity in financial year 2005.

Middle East – Opportunity amidst crisis

The Middle East and Africa oil and gas industry is prone to supply disruptions and political instability but these have not halted investment in the region.

For example, players such as China National Petroleum Corp and Petronas plan to spend US$700mil on developing oil fields in Sudan.

Sudan plans to more than double its crude oil production by mid-2005 to 600,000 barrels a day. Plans are also underway to expand the capacity of its two biggest refineries and building new pipelines to boost exports.

The reconstruction of post-war Iraq could also offer new jobs to KNM when the stability returns. Presently, KNM has tied up with agents in Kuwait, Oman, Jordan, Iran, Qatar and Nigeria.

Quantum leap through joint venture with FBM-Hudson

The recent joint venture with FBM-Hudson Italiana SpA for the acquisition of a 50% equity interest in FBM's manufacturing plant in Jebel Ali Free Zone, Dubai would pave the way for expansion to Middle East and North Africa markets.

FBM is one of the two world leaders in air-cooled heat exchangers for the oil, gas and petrochemical industry. KNM will benefit from technology transfer and expansion of project range.

KNM has joint and exclusive manufacturing agreement and marketing of FBM's process equipment within the Asean and China regions.

The entire arrangement is expected to be completed by the third quarter of 2004. We have factored in the guaranteed cash dividend from FBM of Euro1.8,mil, Euro2mil and Euro2.25mil respectively for the next 3 years to KNM.

Mitigating increase in raw material prices

Steel-related materials accounted for 40% of total operating cost. The raw materials are mainly imported and denominated in US dollar.

Despite the recent rise in steel prices, KNM's prudent raw material purchasing policy has maintained a favorable profit margin. This is evidenced in the improving operating profit margin to 13.4% for FY03 compared with 12% for FY02.

For raw material procurement, KNM usually has a back-to-back arrangement with the customers whereby the costing of raw materials (including any forward purchases) is built into its projects. This has mitigated the cost pressure.

Bonus issue and stock split

The company has proposed a private placement of 5.06 million shares (10% of paid-up capital), bonus issue of 1 for 2 and stock split of 1 into 2.

Upon completion of the exercise, the authorised share capital will increase to RM200 million comprising of 400 million sub-divided KNM shares. This will improve the liquidity of the stock.

The company is also targeting to transfer its listing to the main board by August 2004, on the first anniversary of its listing on the second board of Bursa Malaysia.

Valuation

We continue to like KNM for its robust overseas expansion. We have upgraded our earnings forecast by 5.4% for FY05 based on the enlarged order book and guaranteed cash dividend from FBM joint venture.

We believe prospects for KNM to continue to be bright driven by sustainable strong demand for fuel oil in the Asia region especially China.

In addition, high oil prices will revive upstream activity as well as downstream development, thus spurring demand for process equipment.

Trading at price earnings ratio (PER) of 16.7 times (x) and 8.8x for FY04 and FY05 respectively, we reaffirm our buy recommendation on KNM. Target price of RM5.40 is based on 11x PER for FY05.