KNM rides on green energy

With several renewable energy jobs in the pipeline, it is set to weather economic uncertainties

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GREEN is the new black for KNM Group Bhd.

The oil and gas (O&G) downstream player, which specialises in process-equipment manufacturing, is rewriting its growth story by transforming into a renewable energy major.

And it is optimistic that it will begin to reap the rewards of its business transformation plan once its first renewable energy project – a 72%-owned bio-ethanol plant in Thailand – kicks off in the fourth quarter of 2016.

"Now, we see the 'fruits' hanging, ready to be plucked; and we expect to start plucking them by the end of this year," says KNM chief executive officer Lee Swee Eng.

Lee tells *StarBizWeek* that with the first-phase of the group's bio-ethanol project in Thailand, which comes with a daily capacity of 200,000 litres, coming on stream next quarter, the renewable energy sector will account for 15% to 20% of the group's earnings for the financial year ending Dec 31, 2017.

That is an income of at least RM15mil per year.

According to Lee, contributions from the new business to group's earnings will progressively grow, as KNM still has the second phase of the Thai bio-ethanol project and the first phase of its 80%-owned waste-to-energy plant in Peterborough, UK, in the pipeline for commissioning in 2018.

"We expect the renewable energy business to account for 30%-40% of our group earnings in 2018, and by the next five years, this portion will grow to 70%," Lee says.

"We are moving very actively in this space," he notes.

Renewal energy play

The second phase of KNM's bio-ethanol project in Thailand that also comes with a daily capacity of 200,000 litres is expected to be commissioned in mid-2018.

As for the group's Peterborough project, the first phase of the waste-to-energy plant will see production of 18MW of electricity in the first quarter of 2018, with projected earnings of about RM50mil per year.

Any doubt about the execution of KNM's Peterborough project has been diminished since the group managed to secure £35mil (RM187.7mil) loan from the Export-Import Bank of Malaysia two months ago to part finance the development and construction of the first phase of the plant.

The eventual plan is to expand the Peterborough plant in phases to reach the maximum capacity of 80MW over a five-year period. Besides the overseas projects, KNM is currently also involved in two renewable energy projects in Negri Sembilan, including the RM268mil engineering, procurement, construction and commissioning contract for a waste-to-energy plant in Ladang Tanah Merah.

"So, you can see, we are becoming more and more of a renewable-energy play – both in the contracting side as well as the developer-operator side," Lee says.

Recurring income stream

According to Lee, KNM's business transformation is premised on the need to build a recurring income stream to ensure resilience and sustainable growth. This conviction comes after learning some hard lessons from the aftermath of the 2008/09 global financial crisis.

"It was a wake-up call for us; prior to 2008, we were very dependent on contracting income to drive growth, and we had no concerns then about whether it was a contract or recurring income because customers keep knocking on our doors to give us orders," Lee recalls the heydays of KNM, once a darling stock in the local bourse.

"The business landscape changed after 2008, whereby the contracting environment became very volatile, resulting in our business slowing tremendously, and our earnings being impacted negatively," Lee says.

The last eight years have seen the company undergoing a restructuring exercise, which included strengthening its balance sheet, disposing of its loss-making subsidiaries, and diversifying into the business of developing and producing renewable energy to smoothen its revenue and earnings stream.

"We remain focused on doing what we know best – bio-fuel – where we already have the expertise and experience," Lee says.

With the few renewable energy projects in the pipeline, Lee says, the company is better positioned to weather economic uncertainties. "We are a bit more resilient now, and less susceptible to cyclical factors," he points out.

Lee: 'We expect the renewable energy business to account for 30%-40% of our group earnings in 2018, and by the next five years, this portion will grow to 70%.'

Opportunities in Thailand

KNM views its bio-ethanol project in Thailand as a launchpad for even more renewable energy projects in the country.

"We are smelling opportunities, as the Thai government is exploring production of renewable energy from waste.

"We expect that by end of 2016, the Thai government will announce a legislation to allow the country's municipal councils to contract out waste management for renewable energy on a long-term basis, and when that happens, the market will become even more attractive," Lee says, noting that Thailand has good tariff rates for renewable energy.

At present, though, the company is already enjoying tax incentives, amounting to about nine baht per litre, for its bio-ethanol project in Thailand.

"One thing good about the project in Thailand is that we have a tax incentive for 18 years after commissioning, that is, up to 2036. This is positive for our net earnings and it will help build up a long-term recurring income stream for the company," Lee says.

Positive impact from Brexit

Despite the economic uncertainties in the UK, particularly after the UK referendum to leave the European Union (EU), KNM remains bullish about its renewable energy prospects there.

"The UK government is at the forefront of promoting renewable energy... we don't think Brexit will cause the country to reverse its commitment and policy stance to promote green energy," Lee says, noting that the country has a target of 15% final energy consumption from renewable sources by 2020.

"So, our renewable energy prospects there remain intact as far as incentives and potential power sale are concerned," he adds.

In fact, Brexit will likely work in the favour of KNM's waste-to-energy project in the country, as the UK will likely have to cut down on its shipment of waste to the EU, as cost of export is expected to increase because of Brexit.

"This implies that there will be more waste will be available for us there, and we will probably be paid a better premium to take it from the UK municipal councils because the country has no more landfill space, and if it would cost them 20% more to export to the EU, they might as well pay us 5%-10% more to take the waste for production of renewable energy," Lee explains.

According to Lee, 50% of the revenue stream of KNM's upcoming Peterborough project is expected to come from the fees it gets for collecting waste from municipal councils for combustion. The other half will be made up of 25% incentives, and 25% income from sale of electricity.

So, with the fees for waste management accounting for the bulk of its Peterborough project, any potential increase will have a significant positive impact on the group's bottom line. It will also help offset the risk of lower electricity sale or prices in the event of an economic slowdown.

While renewable energy is the future for KNM, the group is in no way neglecting its business in the downstream O&G industry, which is booming currently because of low oil prices.

"We are getting a steady flow of projects because costs are now lower for downstream players like us with oil prices going down," Lee explains.

Since the beginning of 2016, KNM has won a collective RM326mil worth of contracts locally, with RM151mil of them coming from the refinery and petrochemical integrated development project, or Rapid, in Pengerang, Johor.

Lee reveals that KNM is eyeing potential tenders worth RM1.5bil to RM2bil in Pengerang. Being a local player, he says, KNM will likely stand a better chance to win more contracts in the multi-billion ringgit project of Petroliam Nasional Bhd.

With a solid order book of about RM5bil, and renewable energy project kicking off soon, Lee believes the group will be able to weather the current global economic uncertainties.

KNM expects its existing order book to keep the company busy for about two to three years, after which, the group expects its renewable-energy income stream to reach maturity and start driving the company's growth.

For the first quarter of 2016, KNM saw its net profit fall 69% to RM10.8mil from RM35.1mil in the corresponding period last year. The lower earnings were mainly due to recognition of a one-off gain arising from the disposal of Australian operations in the first quarter of 2015.

During the quarter in review, the group's revenue grew 15.3% to RM397.1mil from RM344.4mil in the previous corresponding period.

At its closing price of 40.5 sen yesterday, KNM's shares currently trade at an undemanding 9.6 times its estimated earnings for 2016, and 7.6 times 2017 estimated earnings.

Of the three brokerages polled by *Bloomberg*, two recommended "buy" on KNM, and one rated the counter a "hold", with the target price averaging at 63 sen.

Recurring income stream: The first phase of KNM's bio-ethanol plant in Thailand will be coming onstream in the fourth quarter of this year. The first phase of this project, which comes with a daily capacity of 200,000 litres, will contribute to about 15%-20% of its bottom line for the financial year ending Dec 31, 2017.

From billionaire to millionaire in less than four months

ABOUT nine years ago, KNM Group Bhd chief executive Lee Swee Eng was easily worth more than RM2bil on paper. That was the time when KNM, a manufacturer of process equipment for the oil and gas (O&G) industry, was the darling of the O&G run and in the news almost every week.

At its height in 2007, the company's market capitalisation was about RM8bil. His stake of about 26% in the company propelled Lee into Malaysia's billionaire list.

In mid-2008, a confluence of factors reduced his paper wealth by more than 80%, as the company's market capitalisation reduced to less than RM1.5bil.

It all started with the Transmile Bhd accounting fraud that cast a shadow of doubt on all active stocks on Bursa Malaysia.

KNM, which was a favourite then among investors, felt the heat from the Transmile scandal.

Then, the sub-prime crisis in the United States started to bog down global markets from mid-2008 onwards. Oil prices fell from their dizzy heights of US$100 per barrel and this impacted sentiment on companies in the sector, KNM included.

Then came the financial crisis in the final quarter of 2008 after the collapse of Lehman Brothers. It triggered a liquidity crunch and ripped stock markets across the globe apart.

During this time, KNM was struggling to overcome its financial woes after a large expansion in Europe in early 2008. The company acquired German-based Borsig, a company that has a strong technological and manufacturing presence in the area of waste heat recovery systems.

The Borsig price tag was 350 million euros (RM1.67bil) then. To complete the acquisition, KNM undertook a rights issue of RM2.2bil. After utilising the proceeds of the rights issue to settle a portion of the 350 million euros, there was a sum of 150 million euros left that was to be settled via an exchangeable bond issue.

The poor stock market sentiment, coupled with the liquidity crunch and oil price crash, caused its financing plans to go haywire. KNM had to abort its bond issue. As it negotiated with the banks to convert the 150 million euros into a long-term loan, the stock took a beating.

Within four months of June 2008, it fell from RM2.20 to less than 70 sen. Lee had to sell some of his shares to cover his margin positions. Since then, KNM and Lee have no longer been in the news except in June 2010 when he and another party explored the idea of taking KNM private. The deal failed.

After an almost eight-year hiatus, Lee is finally speaking to the media again.

A close associate says that the single-largest shareholder of KNM, with a 21.2% stake, has been waiting for the right moment to talk about the company's transformation into a renewable energy player, which he says is bearing fruit.

Below are excerpts of the interview.

Can you update us on how KNM's transformation into a renewable energy major is progressing?

We are making good progress in this space, with the first phase of our bio-ethanol plant in Thailand coming onstream in the fourth quarter of this year. The first phase of this project, which comes with a daily capacity of 200,000 litres, will contribute to about 15%-20% of our bottom line for the financial year ending Dec 31, 2017.

By mid-2018, the second phase of our bio-ethanol plant, which has a similar capacity of 200,000 litres per day, will come onstream.

We also have a waste-to-energy project in Peterborough, the UK, which will see the first phase involving a capacity of 18MW starting commercial operations by the first quarter of 2018. For the Peterborough project, we have planning approval for up to an 80MW capacity. So, we have 80% more to develop in the future. We will do this in phases, with the aim of achieving the maximum capacity within five years.

We are moving very actively in this.

But over and above that, the opportunities for us to get contracts in the waste-to-energy segment are also strengthening. Locally, we have already secured two of such projects in Negri Sembilan. So, you can see we are becoming more and more of a renewable energy player – both on the contracting side as well as the developer-operator side.

What drove you to undertake such transformation?

The whole idea is to develop a business model to generate a recurring income stream for the company so that it will be more resilient and less susceptible to cyclical factors.

We got our wake-up call in the aftermath of the 2008/09 global financial crisis. Prior to 2008, we were very dependent on contracting income to drive growth, and at that time, nobody really cared whether it was a contract or recurring income because customers kept knocking on our doors to give us orders.

But the business landscape changed after 2008. The contracting environment became very volatile and we were hit. After 2008, we tried to rebuild the company in several ways. The first thing we did was to enhance our balance sheet, and then, dispose of our "bleeding" subsidiaries.

The third thing we are doing is moving into a recurring income business model, focusing on what we know best, that is, bio-fuel projects, where we have expertise in the processing side and also through our historical experience through Borsig where we gained experience in waste-to-energy technology.

When will renewable energy start contributing to the group?

We will reap the fruits by the end of this year.

Contributions from the renewable energy segment will account for 15%-20% of the group's income for 2017.

Then, with contributions from our 18MW Peterborough waste-to-energy project and the second phase of our Thai bio-ethanol project coming in when they become operational, we expect the renewable energy segment to account for 30%-40% of our total income in 2018, and this will eventually grow to 70% by the next five years.

How profitable is your bio-ethanol plant in Thailand and the Peterborough project?

In the first phase of the Thai project, we expect a net profit of RM10mil per year.

As for the Peterborough project, at an 18MW capacity, we are looking at a net profit of RM50mil per year.

One thing good about our project in Thailand is that we have a tax incentive for 18 years after commissioning, that is until 2036. The incentive gives something like nine baht (RM1.05) per litre, and that gives us good security in terms of a stable recurring income.

For our Peterborough project, 50% of the income will come from the fees for the waste we collect from municipal councils. And we expect this fee to increase, as the country has no more landfill space, and with Brexit, the country will be subject to about 20% tax if it exports waste to the European Union (EU), which it is currently doing tax-free.

If the UK had to pay 20% more for exporting waste to the EU, then it might as well pay us 5%-10% more to take the waste to produce energy.

The other half of the income of our Peterborough project will be made up of 25% government incentives and 25% electricity sale.

With this transition, does it mean that there will be less focus on your original business?

We will still continue to expand our contracting business in the downstream O&G segment, and contribution from this segment will continue to grow, along with our renewable energy business.

The only thing is that our contracting business will feature less prominently when contributions from the renewable energy segment reaches maturity. For instance, our income structure in the next five years will be 70% renewable energy and 30% contracting.

With our renewable energy segment being a recurring income business, we will be more resilient.

Are you looking to buy any potential new assets?

No, we are not actively looking around. But of course, if good opportunities arise, we will consider, but they have to be one that can enhance our recurring income stream and add to our core competencies.

Our cash pile of RM130mil is mainly to cater to our working capital.

How would you manage in the event of another global economic downturn on the horizon?

We don't think we will be badly hit. Our existing order book can keep us busy for at least two to three years. After that, our renewable energy will reach maturity stage and we will see our earnings being further strengthened, and by then, the economic environment would likely have stabilised.

Is the low oil price environment negatively affecting you?

Our problem today is market perception. Just because we are in the O&G industry, the market thinks we are in a dreadful position now because of the low oil prices. They don't differentiate between a downstream and upstream player.

We are a downstream player, catering to the petrochemical and refining segment. Downstream players like us are doing better because the feedstock costs are lower in the current low oil price environment. Projects are coming in for us because there is now more demand for petrochemicals.

How are you addressing the market perception problem?

We are making good progress to address the problem by meeting with fund managers and bankers. The fact is, we will be more resilient going forward and our balance sheet will continue to strengthen. And many are beginning to understand our business model better and see the prospects of our renewable energy. A good indicator of bankers' growing confidence in KNM is the ease of us securing financing from them despite the current challenging environment.

Our low gearing ratio (at 0.27 times as at end-2015) has enabled the company to undertake high-capital expenditure and long-term recurring-income projects. And we are in the position to build our own projects for our recurring income stream.