

12 March 2008

Hallin Marine Subsea International

Year End	Revenue (\$m)	PBT* (\$m)	EPS* (c)	DPS (c)	PE (x)	Yield (%)
12/06	38.9	4.2	10.5	1.9	24.9	0.7
12/07	64.8	11.2	23.7	2.0	11.0	0.8
12/08e	86.0	13.4	27.8	2.2	9.4	0.8
12/09e	102.0	15.4	30.9	2.4	8.4	0.9

Note: *PBT and EPS (fully diluted) are normalised, excluding goodwill amortisation and exceptional items.

Valuation assumes average rates historically and \$/£2.00 in 2008 and 2009.

Investment summary: Smooth sailing

An excellent set of results reflect a problem-free year with high fleet utilisation and a strong recovery in gross margins. Hallin Marine looks set for another step up in profitability in 2008 as the size of its fleet grows further and its Engineering division delivers its first sales. After a material earnings upgrade, the valuation looks cheap.

Final results reflect buoyant market

Results were ahead of expectations in all areas. Revenues of \$64.8m were 66.6% higher than the previous year and reflected the expansion of the group's fleet of diving support and remote operating vehicles. Profit before tax of \$11.2m (\$4.2m) beat our expectations (\$7.3m) by some way as the group benefited from a strong gross margin increase due to high utilisation of its assets. Fully diluted EPS was 23.7¢ (10.5¢), which translated into sterling is 11.9p (5.7p). A 1p dividend was declared.

Material earnings upgrade

With a series of major contracts announced in the last six months and an order book of \$90m (\$48m) stretching into 2009, Hallin Marine now has excellent visibility. First contribution from Engineering Services, plus the utilisation of assets being delivered in 2008, easily justifies the c \$20m uplift in revenues. We forecast a continuation of high utilisation and gross margins as the group benefits from buoyant markets. We have upgraded our 2008 and 2009 earnings forecasts by over 40%.

Sensitivities

Control of cash flow and execution of contracts remain the major sensitivities entering 2008. Bringing assets on stream effectively and maintaining high utilisation is key to protecting the high gross margins.

Valuation: Visibility and critical mass bring re-rating

Hallin Marine now looks like a credible player in the subsea contracting market. It has a higher visibility to its earnings and in our view deserves a higher rating to reflect this. Increasingly comparisons with larger peers look valid, justifying a rating of 10–12x.

Price 130.5p
Market Cap £52m

Share price graph



Share details

Code HMS
Listing AIM
Sector Oil & Gas
Shares in issue 40.0m

Price

52 week High 131p Low 59p

Balance Sheet at 31 December 2007

Debt/Equity (%) 59
NAV per share (c) 84.2
Net borrowings (\$m) 19.9

Business

Hallin Marine is an oilfield services group based in Singapore. The group specialises in the installation, repair and maintenance of subsea installations for the oil and gas industry.

Valuation

	2007	2008e	2009e
P/E Relative	76%	77%	74%
P/CF	3.4	5.4	7.2
EV/Sales	2.2	1.6	1.9
ROE	30%	23%	21%

Revenues by geography

UK	Europe	US	Other
25%	0%	14%	61%

Analyst

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Final results show rapid growth

Key figures (reported in US\$)

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Exhibit 1: Key figures

	2007		2006	
	\$m	£m	\$m	£m
Sales	64.8	32.4	38.9	21.1
Gross profit	19.2	9.6	5.9	3.2
Margin (%)	29.6	29.6	15.1	15.1
PTP	11.2	5.6	4.2	2.3
EPS	23.7	11.9	10.5	5.7
DPS		1.0		1.0

Source: Edison Investment Research estimates

During the year Hallin Marine's forward order book has risen from \$48m to \$90m. This reflects a series of major contract wins with the two-year diving support contract for *Sanko Angel* and the manufacturing contracts for subsea equipment providing strong long term visibility for the group. Over 30% of the order book now extends into 2009, which is the first time Hallin has a longer horizon than 12 months.

Gross margins in 2006 were adversely affected by a weaker utilisation due a planned SAT system overhaul and by one particular contract dispute. We had been expecting a gross margin in the region of 24%, and the higher figure reflects utilisation above 80% for all assets and over 90% on the main diving support vessel (DSV) *Sanko Angel*. The strength of the underlying markets creating such high demand for the assets has minimised the gaps between contracts and pushed utilisation rates up for the whole industry from a more normal 70–80%.

The results included a profit of \$3.1m (\$3.3m) from the disposal of one saturation diving (SAT) system, the same as in 2006. Sale of older assets remains a part of the group strategy, especially now it is manufacturing in-house for both internal and external sale, and we treat this as an ongoing profit stream, not an exceptional.

Net debt at the year end was \$19.9m, again better than we had expected. The major feature was the £37.6m spent on assets (depreciation \$3m) as the build programme of *Ullswater* continued and two new remote operating vehicles (ROVs) were purchased on top of the normal replacement cycle for SAT systems.

Divisional performance and 2008 outlook

Hallin Marine manages its business as Eastern, Western and Engineering Services divisions. At the moment the Western division manages the entire ROV fleet, while the Eastern division manages the diving support work.

Eastern division – Mix of diving support vessels remains flexible

Revenues increased from \$35.1m to \$43.1m and gross margins rose from 14.8% to 28.9%. *Toisa Voyager* completed its Gulf of Mexico contract midway through the year and its charter ended, while *Sanko Angel* started a three-year charter in Q2 and achieved record utilisation rates over 90%. With several other spot charter vessel contracts during the year, overall the division achieved utilisation rates over 80%.

The recent announcement of a \$40m contract for a firm two years' (and one-year option) diving support contract guarantees *Sanko Angel*'s workload in the current year at high utilisation rates. With fixed input costs (charter rate), Hallin now has a certain and high visibility earnings security on this part of the business. In 2008, Hallin is again taking a low risk strategy in extending its fleet of assets with three new vessels to cover a range of options.

It has chartered the *Seacor Penrith* on a three-year term essentially to replace the capacity lost from *Toisa Voyager*. This is a smaller diving support vessel with ROV and again aims to address segments in the market where many of the larger vessels are not economic. *Dea Surveyor* has been chartered for 12 months. It is a boat Hallin has already chartered for short periods in 2007 and again is smaller, addressing specific niches. *SOV Ullswater* should be delivered in Q4. We are currently assuming it makes no contribution to revenues in 2008, however the sale and leaseback scheme on completion is in our estimates showing a material cash in flow at year end. *Ullswater* will be a high specification vessel capable of commanding a premium day rate. This mix of assets gives Hallin a mixture of size of vessel, specification and term of contract, which should maintain its flexibility and ensure good utilisation rates continue in the current year.

Our expectation for 2008 is about a 10% increase in revenues based on these capacity assumptions. There is every reason to believe that utilisation rates will remain high as the demand outlook is favourable for the next three to four years (see Market outlook). Day rates for boats continue to remain firm and Hallin has consciously extended its fleet in areas where there is a shortage of capacity. This argues for a maintenance in the gross margin at around 28-29%.

Western division: ROV fleet scales up

This is the first full year contribution from Remote Operating Vehicles, which was set up in May 2006 in Aberdeen. The division produced revenues of \$21.6m, with gross margins just above 30%, which is a creditable result considering it was a new start-up. In 2007, Hallin increased the number of larger construction and work class from four to six in mid year, and took delivery of the first two electric inspection class units. The business is still growing rapidly with new units being built in-house and on order externally. Expansion is at the request of clients and we highlighted last September how Hallin plans to operate a range of ROVs. The scale can best be judged by the purchase prices that range from \$0.35m up to \$3m and this is a loose guide for the relative scale of day rates that can be achieved with these units. During 2008, we expect some significant additions to the fleet.

These include: 1) four working class 'C-ROV' ROVs, built in-house and delivered progressively throughout the year. We estimate these cost c \$1.5m; (2) seven electric inspection class ROVs delivered through the year up until September in two different size/specs. (Four costing c \$1m

each and three costing \$0.35m each); and (3) charter of the *RSS Shackleton* as an ROV support vessel on a four-month charter. Not having operated a ROV support vessel before, management is keen to test its viability with a short-term charter before it is extended.

With an average of five units operating in 2007, we expect this to rise to an average of about 12 in 2008, though at a lower average day rate reflecting the mix of smaller units. By year end we expect the fleet size to be over 20 units. We estimate this capacity increase equates to about a 30% increase in revenues.

Engineering Services: Facilities in place to produce profits this year

Although the business made no revenue or profit contribution in 2007, it has made significant progress in the last six months. Firstly it continues to build operational assets for Hallin. Work is currently underway on three further C-ROV systems (capacity expansion) and two SAT systems (capacity replacement); and secondly it has an order book of about \$20m including the announced order of a two new SAT systems for US and Singaporean customers.

Given the step up in its workload, the capacity of its Singapore yard is being extended by 50% in April so that ROVs can be built in the new area and more than one SAT system can be built simultaneously. Even with the new capacity, the order book covers the yard at full capacity until well into 2009.

Management of this division has also taken over responsibilities for procurement of new assets like DSVs (*Ullswater* and *Windamerè*) and ROVs, keeping the other divisions firmly focused on service. We also expect the sale of older assets to continue. Although Hallin had previously announced a potential sale of a SAT system in the autumn, this fell through. We understand it has several other interested parties and have assumed this is completed in H1 as originally in our forecasts.

Changes to forecasts: Material upgrade

We continue to estimate future earnings by modelling day rate, utilisation and gross margin assumptions for each of the major assets. Brushing over the complexities of this process, we have highlighted our main assumptions below:

- Day rates remaining stable; this looks to be conservative in the face of a continuing high demand and shortage of diving support assets.
- High utilisation rates at over 80%, as in 2007.
- Gross margins maintained close to 2007 levels (ie 28%). The *Sanko Angel* contract gives a much higher level of certainty on predicting gross margins this year. A greater mix of spot charter vessels may depress margins this year, however this should be balanced by healthy margins on the manufacturing business.

Exhibit 2: Changes to forecasts

\$m	2008 New	2008 Old	2009 New	2009 Old
Sales	86.0	70.0	102.0	85.0
PTP	13.4	8.6	15.4	11.0
EPS	27.8	19.2	30.9	22.9

Source: Edison Investment Research estimates

The scale of these upgrades does look extreme but the revenue increase is firmly supported by new capacity additions, while operational performance did not benefit from any exceptional events last year. We have scaled back our expectations for the exceptional gain on sale and leaseback of *SOV Ullswater* from \$9m to \$7m. Although the contract remains on schedule, this reflects the rise in input costs over the last year and in 2008. Our new divisional breakdown is shown below:

Exhibit 3: Divisional breakdown

	2005	2006	2007	2008e	2009e
Sales					
Diving	26,566	35,141	43,154	48,000	58,900
ROV	0	3,724	21,600	28,000	33,100
Engineering Services	0	0	0	10,000	10,000
Total sales	26,566	38,865	64,754	86,000	102,000
Diving	5,024	5,194	12,484	12,900	17,000
ROV	0	682	6,709	8,300	9,760
Engineering Services	0	0	0	2,900	3,000
Gross Profit (after dep'n)	5,024	5,876	19,193	24,100	29,760
Asset sales	0	3,367	3,151	3,000	1,500
Exceptional gain	0	0	0	7,000	0
Total	5,024	9,383	22,344	24,100	29,760
Gross Margins	18.9%	15.1%	29.6%	28.0%	29.2%

Source: Edison Investment Research NB 2006 Diving revenues and profits hit by \$1.65m charge.

Market outlook remains very positive

Trends within the offshore industry remain extremely positive as the two charts below show demand remains very strong. The continuation of the high oil price is bringing about further steps up in capital expenditure from the oil and gas majors. While development and production costs have risen, there are still strong economic grounds to continue spending in the offshore industry for at least the next four years. BP has raised its hurdle rate for investment from \$40 to \$60 per barrel, but this still leaves ample margin to continue investment.

Against this background, the key issues for Hallin Marine are control of its costs and maintaining inflation in its own day rates. While divers' costs rose dramatically in 2006, the rise in divers' rates in the last year has been more orderly and while there is a shortage of divers, equipment is also a limiting factor. For Hallin this is less important as it is now a smaller ingredient of the much larger subsea packages that it is offering. And it is training its own ex Philippine navy divers to alleviate potential shortages. On new bids it is typically quoting a rolling 45-day contract for revising variable costs, to minimise its exposure to cost escalation.

On the issue of capacity, recent additions of diving support vessels on a mixture of different length contracts give it good flexibility on input costs. There is no sign yet that the planned increase in subsea assets is nearing overcapacity. In fact clients are increasingly keen to book assets for longer time periods to mitigate against the shortage of diving support vessels.

While platform support vessels represent the commodity end of the sector and may well reach oversupply by next year, most of the more technical support vessels remain in short supply. The global diving support vessel fleet is still fairly old and most of the new build is concentrated at the

larger end, which is why Hallin has focused on operating and building smaller vessels. Hallin Marine does face competition in supply of SAT systems, however it still has a much lower price than others based on its low-cost yard, and there is a large increase in global ROV capacity planned, which may eventually swamp the market, but not in the short term.

Sensitivities

Financials: Cash flow control achieved by sale and leaseback

Although we have made material revision upwards in our profit expectations, we have not materially changed our expectations for asset expenditure. This remains one of the big sensitivities for the group as it aims to match its capacity with demand. Sale and leaseback of *SOV Ullswater* (due at year end) helps release cash (c \$42m) to fund purchase of another boat. This keeps the build up in debt manageable and we forecast gearing to fall to about 40% at year end despite a further \$50m investment in new assets.

Execution remains key

Utilisation rates at over 80% reflected a problem-free year for Hallin Marine. We remain aware that utilisation and hence gross margins depend on smooth transition between contracts and no breakdowns. With a larger size of subsea contract the specific risk has increased in 2008, although this is mitigated by the high visibility on *Sanko Angel*'s earnings stream.

Valuation – underlying earnings stream is clearer

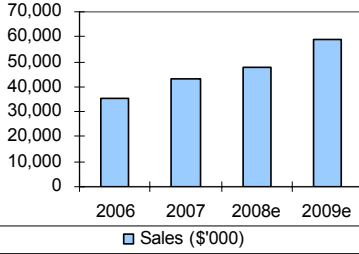
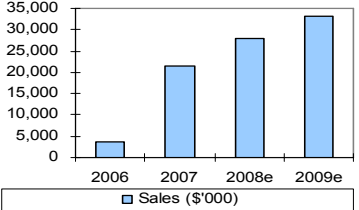
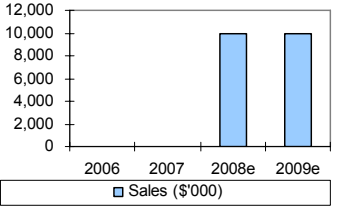
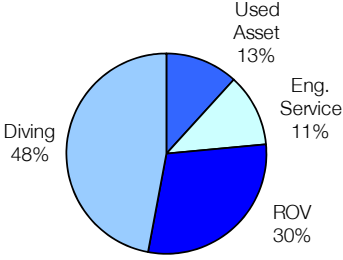
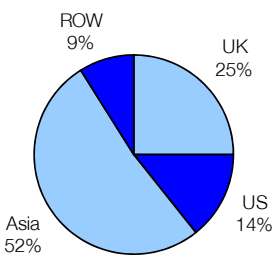
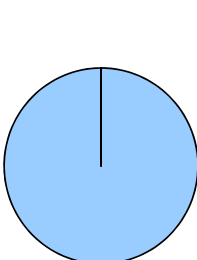
We think there is a clear case for a re-rating for Hallin Marine based on three factors: 1) positive earnings momentum continuing, backed by the buoyant market; 2) structure and strategy are now much more akin to its bigger subsea contracting competitors; and 3) improved visibility of earnings. Based on the criteria above, we think that a fair rating for Hallin would be 10–12x (2008 P/E).

Exhibit 4: Peer group comparison (prices as at 10 March 2008)

Company	Business Description	Currency	Price	Mkt Cap	2008		2008	
					Sales	EPS	P/E	EV/Sales
Small Size Oil Service								
Hallin Marine	Diving services	£/p	121	48	43.0	13.9	8.7	1.4
Getech	Geotechnical services	£/p	21	6	3.5	2.2	9.3	0.4
RheoChem	Drilling fluids	£/p	12	13	13.0	1.6	7.7	0.9
Offshore H-C Mapping	Geophysical exploration	£/p	92	39	19.8	-10.2	N/A	1.0
Sovereign	Personnel and eng services	£/p	50	9	92.0	8.0	7.6	0.4
Plexus	Oil and gas wellheads	£/p	41	32	13.1	4.3	14.0	2.6
Medium Size Oil Service								
Cape	Maintenance and services	£/p	255	290	571.0	25.3	10.1	0.5
James Fisher	Offshore support, oil transport	£/p	598	298	202.0	37.6	15.9	1.8
Hunting	Pipe connectors and transportation	£/p	803	1,052	2,050.0	47.6	16.9	0.6
Expro	Service, personnel and equipment	£/p	1208	1,334	600.0	52.5	24.0	2.1
Contractors with diving services								
Helix		\$/c	33	3,047	2,300.0	3.6	9.1	1.8
Global Industries		\$/c	18	2,036	1,180.0	1.6	11.4	1.4
Technip		Eur/c	54	5,724	8,600.0	3.0	18.0	0.5
Oceaneering International		\$/c	59	3,258	1,950.0	3.7	15.9	1.8

Source: Hemscott, Bloomberg, Edison Investment Research

Exhibit 5: Company fact sheet

Operations	Performance										
<p>Diving Support: Eastern Division</p> <p>Hallin Marine operates a fleet of dynamically positioned (DP) diving support vessels (DSV). It increasingly supplies a full range of subsea contracting rather than just diving support. The business operates mainly in the Far East with headquarters in Singapore. It operates a mixture of assets including long-term charter and spot charter vessels. In 2008, <i>Sanko Angel</i> is on three-year charter alongside two smaller DSVs on spot charter, while SOV Ullswater is scheduled for delivery in Q4 on a 10-year fixed price charter. <i>Sanko Angel</i> now has a two year fixed price contract worth c \$40m. Vessels are typically 70m long and facilitate 100 people as crew; performing saturation diving, air diving and remote operated vehicles. Another owned vessel, <i>DSV Windamere</i>, has just started being built for delivery in early 2010. The saturation diving (SAT) systems allow divers to live in pressurised living quarters at the same pressure as they work on the sea bed in depths over 50m. Hallin operates SAT systems on its DSVs (see above) and also currently has five SAT systems, which operate from third party vessels. An SDS crew is typically 21 people supporting four divers. An air diving system (ADS) is used in shallow waters (normally less than 25m). Hallin currently operates two sets of ADS'.</p> <p><i>Main competitors: Cal Dive International, Global Industries.</i></p>	 <table border="1"> <caption>Sales (\$'000)</caption> <thead> <tr> <th>Year</th> <th>Sales (\$'000)</th> </tr> </thead> <tbody> <tr> <td>2006</td> <td>35,000</td> </tr> <tr> <td>2007</td> <td>45,000</td> </tr> <tr> <td>2008e</td> <td>50,000</td> </tr> <tr> <td>2009e</td> <td>60,000</td> </tr> </tbody> </table>	Year	Sales (\$'000)	2006	35,000	2007	45,000	2008e	50,000	2009e	60,000
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<p>Remote Operating Vehicles: Western Division</p> <p>Although Hallin has operated ROVs from DSVs for many years, it only set up a separate ROV operation in 2006. The business is based in Aberdeen. Hallin initially purchased four high specification ROVs for operation in the North Sea. By the end of 2008, it will have a range of work class, mid-range and inspection class ROVs, building a fleet of potentially over 20 vehicles. ROVs are on charter in the North Sea, Africa and the Gulf of Mexico.</p>	 <table border="1"> <caption>Sales (\$'000)</caption> <thead> <tr> <th>Year</th> <th>Sales (\$'000)</th> </tr> </thead> <tbody> <tr> <td>2006</td> <td>5,000</td> </tr> <tr> <td>2007</td> <td>20,000</td> </tr> <tr> <td>2008e</td> <td>28,000</td> </tr> <tr> <td>2009e</td> <td>32,000</td> </tr> </tbody> </table>	Year	Sales (\$'000)	2006	5,000	2007	20,000	2008e	28,000	2009e	32,000
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<p>Engineering Services</p> <p>Hallin manufactures its own SAT systems at its Singapore leased yard at a cost of c \$3.0m and can currently sell them at a significant premium to the short-supplied US market. It has sold used units in both 2006 and 2007 and has now won orders to manufacture a new unit for external sale. It is also currently in the process of building a system for its own vessel and one unit a year to replace the one sold. In 2007, Hallin started building its own low specification ROVs as well.</p>	 <table border="1"> <caption>Sales (\$'000)</caption> <thead> <tr> <th>Year</th> <th>Sales (\$'000)</th> </tr> </thead> <tbody> <tr> <td>2006</td> <td>0</td> </tr> <tr> <td>2007</td> <td>0</td> </tr> <tr> <td>2008e</td> <td>10,000</td> </tr> <tr> <td>2009e</td> <td>10,000</td> </tr> </tbody> </table>	Year	Sales (\$'000)	2006	0	2007	0	2008e	10,000	2009e	10,000
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<p>Divisional breakdown</p>  <p>Based on 2008e gross profits</p>	<p>Geographic breakdown</p>  <p>Based on 2007 sales</p>	<p>Customer breakdown</p>  <p>Based on 2007 sales</p>									

Source: Edison Investment Research

Exhibit 6: Financials

Year-ending 31 December	\$'000s	2005	2006	2007	2008e	2009e
Accounting basis		IAS	IAS	IAS	IAS	IAS
PROFIT & LOSS						
Revenue		26,566	38,865	64,754	86,000	102,000
Cost of Sales		(21,542)	(32,989)	(45,560)	(61,900)	(72,236)
Gross Profit (after depreciation)		5,024	5,876	19,194	24,100	29,764
EBITDA		2,941	1,320	14,827	19,400	24,500
Operating Profit (before GW and except.)		2,451	3,778	11,852	15,400	18,000
Goodwill Amortisation		0	0	0	0	0
Exceptionals		0	0	0	7,000	0
Other		(39)	440	0	0	0
Operating Profit		2,412	4,218	11,852	22,400	18,000
Net Interest		(105)	(43)	(652)	(2,000)	(2,600)
Profit Before Tax (norm)		2,307	4,174	11,200	13,400	15,400
Profit Before Tax (FRS 3)		2,307	4,174	11,200	20,400	15,400
Tax		(52)	(278)	(1,159)	(1,662)	(2,310)
Profit After Tax (norm)		2,255	3,896	10,041	11,739	13,090
Profit After Tax (FRS3)		2,255	3,896	10,041	18,739	13,090
Average Number of Shares Outstanding (m)						
		28.7	37.0	40.0	40.0	40.0
EPS - normalised (c)		7.8	10.5	25.1	29.3	32.7
EPS - normalised fully diluted (c)		7.8	10.5	23.7	27.8	30.9
EPS - FRS 3 (c)		7.8	10.5	25.1	46.8	32.7
Dividend per share (c)		1.7	1.9	2.0	2.2	2.4
Margins						
Gross Margin (%)		18.9%	15.1%	29.6%	28.0%	29.2%
EBITDA Margin (%)		11.1%	3.4%	22.9%	22.6%	24.0%
Operating Margin (before GW and except.) (%)		9.2%	9.7%	18.3%	17.9%	17.6%
BALANCE SHEET						
Fixed Assets		7,423	32,727	66,353	74,000	99,700
Intangible Assets		0	0	0	0	0
Tangible Assets		5,621	31,186	64,638	74,000	99,700
Assets held for sale		1,801	1,541	1,715	0	0
Current Assets		9,192	18,349	28,343	25,000	25,000
Work in progress			913	0	2,000	2,000
Debtors		7,279	15,067	20,390	22,000	22,000
Cash		1,913	2,370	7,953	1,000	1,000
Current Liabilities		(7,096)	(14,620)	(36,285)	(29,500)	(20,100)
Creditors		(6,267)	(10,805)	(33,102)	(28,500)	(19,100)
Short term borrowings		(830)	(3,815)	(3,183)	(1,000)	(1,000)
Long Term Liabilities		(332)	(12,185)	(24,711)	(18,700)	(42,500)
Long term borrowings		(324)	(12,147)	(24,668)	(18,700)	(42,500)
Other long term liabilities		(7)	(38)	(43)	0	0
Net Assets		9,187	24,271	33,700	50,800	62,100
CASH FLOW						
Operating Cash Flow		(1,830)	2,081	30,384	19,400	14,500
Net Interest		(234)	(102)	(652)	(2,000)	(2,600)
Tax		(17)	(140)	(574)	(1,662)	(2,310)
Capex		(4,070)	(26,181)	(33,048)	(13,400)	(32,200)
Acquisitions/disposals		0	0	0	0	0
Financing		4,849	10,570	(1,616)	(21)	76
Dividends		0	(580)	(800)	(1,120)	(1,266)
Net Cash Flow		(1,302)	(14,351)	(6,306)	1,198	(23,800)
Opening net debt/(cash)		(2,100)	(759)	13,592	19,898	18,700
HP finance leases initiated		0	0	0	0	0
Closing net debt/(cash)		(798)	13,592	19,898	18,700	42,500

Source: Company accounts/Edison Investment Research

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