Re-Entry Centrica: High gas prices could double net income

Company:	Centrica	**Market Cap:**	£4.82bn
Industry:	Utility	**Net Cash:**	£700mio (+ ~£1.5bn pension deficit)
Country:	UK	**Revenue:**	£18.3bn
Date:	29th March 2022	**Net Income:**	£549mio (3%)
Dividend:	None	**Free Cash Flow:**	£1.17bn (6.4%)
Entry:	£4.88bn	**Target Market Cap:**	£7.5bn

Buying back Centrica

Back in January 2022 I sold Centrica mostly due to seeking better opportunities, near-term risks of customers switching from fixed to the variable Ofgem tariff causing losses for Centrica as well as some uncertainty about margins and low winds. As it turned out, these risks were miniscule and have now subsided. Meanwhile, the invasion of Ukraine by Russia has caused gas prices to spike even further topping out at a whopping £8 per therm. Here is why I bought the position back…

Putin's only weapon left

Unless we enter WWIII fighting Russia in a perhaps nuclear war, Putin only has one weapon left to threaten the West: Gas. As German Economy Minister Habeck said, Germany is planning to end Russian energy imports by the end of the year – all energy apart from gas, which Germany still needs from Russia until mid-2024[1]. The Kremlin has made clear it wants all payments in Rubles by 1st April, while Europe declined any change of currency. Whatever comes out of this conflict, since gas flows from Russia mostly arrive in Europe via pipeline, it is not so easy to divert these flows to Asia via LNG ships. This means we will face higher gas prices for longer, while most other commodities can likely be diverted via existing ships on new routes.

[1] https://www.dw.com/en/germany-seeks-to-wean-itself-off-russian-energy-imports/a-61257187

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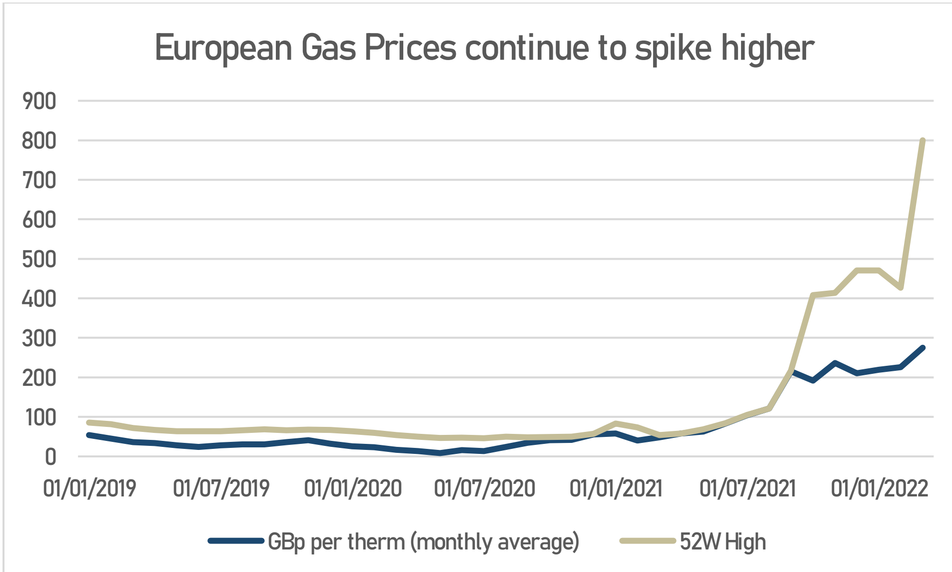

Source: Barchart

The delay in earnings from the Ofgem tariff adjustment

The Ofgem tariff is changed twice a year, in April & October, and is based on the average wholesale energy costs calculated between February and July for the period October to March and between August and January for the period April to September. Since gas prices have only started rising significantly from August, Centrica will only increase their profits from April 2022, and further from October 2022. This means that even for FY 2022, Centrica's British Gas will only make 2.9% of the Ofgem tariff for the average of the 2021/22 winter, 2022 summer and 2022/23 winter period. With 7.26mio British Gas residential customers and an average Ofgem tariff of £1,971 per household in 2022, British Gas will generate around £250mio in operating profits (£200mio net income), considering they make 2.4% profit margins (taken from FY 2021 report rather than Ofgem allowance of 2.9%) and adjusting for £93mio in annual costs. That's double than the £118mio achieved in 2021.

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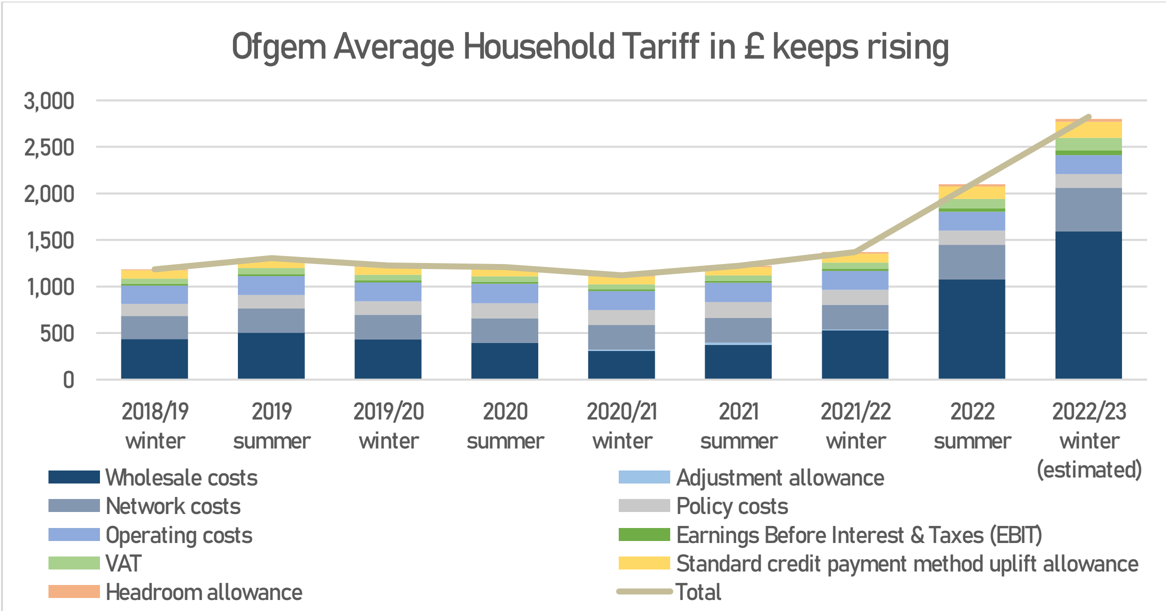

Source: Ofgem

Upstream will be a true cash cow

Spirit Energy sells their gas forward up to 24 months, with each month forward roughly equally covered. The current curve indicates an average of around GBp 200 per therm. Given that Centrica is looking to reduce their capital expenditures and run the field dry over the next 10 years, the production rate will decline by around 10% annually. This means that in 2022 Spirit Energy is going to produce around 940mio therm, and with a break-even of GBp 33 and average sales price of GBp 200 per therm, Spirit Energy is going to achieve £1.57bn in profits. After tax (40%), this will result in £942mio net income and £792mio after capex (£150mio).

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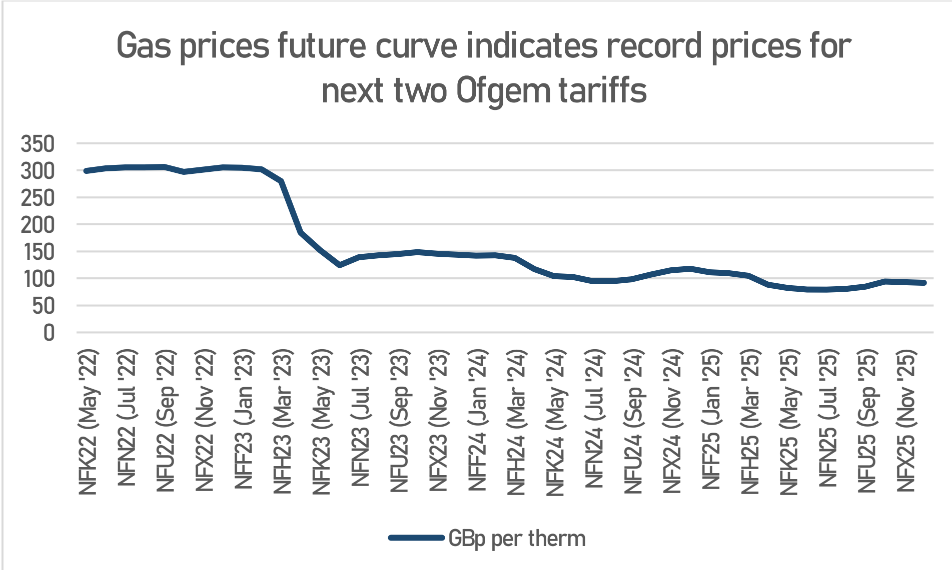

Source: Barchart

Bottom line

Given the year continues roughly in line with the first three months, below are some estimated profit figures for Centrica for 2022 compared to 2021. The net income after capex and pension deficit is a measure to estimate a more useful comparison and I do not specify it as a cash flow, as depreciation, amortization is not added back.

Segment	Adjusted operating profit 2021	Adjusted operating profit 2022 (estimated)
British Gas Services & Solutions	121	**150**
British Gas	118	250
Business Solutions	-52	-40
Bord Gais	28	45
Energy Marketing & Trading	70	**70**
Upstream (commodity tax deducted)	663	1,162
EBIT	948	**1,637**
Interest expense	187	165
Taxation	218	**422**
Net income	543	1,050
Net income (after capex, pension deficit)	-32	**800**

Source: Centrica, Ofgem

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Upstream business will be gone in the next decade

Although Centrica's upstream business is their true cash cow, the business will be wound down and reserves will be depleted within the next ten years. When looking at those profits without the Upstream business, the 2022 estimated net income would only amount to £221mio. If you consider that by then most debt would be paid back, saving Centrica £165mio interest expense annually, net income would be around £340mio. With a current valuation of £4.8bn this appears fairly valued. However, the upstream profits are currently so high that I estimate a fair value of around £7.5bn for the business. This valuation premium of nearly £3bn is due to the relative market valuation of £1bn of Serica, a North Sea upstream gas producer with less than 1/3 of Centrica's gas output. In this sense, owning Centrica is a hedge for the portfolio amidst rising energy prices, which affects nearly all other businesses.

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