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Update Turnaround: Centrica, a hidden cash cow. Spirit Energy Norway sold

Company:	Centrica	**Market Cap:**	£4bn
Industry:	Utility	**Net Debt:**	£0 (+ ~£1.5bn pension deficit)
Country:	UK	**Revenue:**	£16bn
Date:	9th December 2021	**Net Income:**	£200mio (1.25%)
Dividend:	None	**Free Cash Flow:**	£1bn (6.25%)
Entry:	£3.1bn	**Target market cap:**	£4.5bn to £6bn

Update: Spirit Energy Norway sold

Yesterday, Centrica announced the sale of Spirit Energy Norway[1] for around $1.026bn to Sval Energi AS (Statfjord field) and $50mio to Equinor Energy AS (Stratfjord field), which is around £800mio combined. However, Centrica is only receiving their 69% share of the receipts (£560mio), and will lose all of their share of £376mio (£260mio) 2021 net cash flows as of 1st October 2021 (although they are still subject to a 70% tax rate), and will not be reimbursed for the £180mio hedging losses for the year, which will bring the cash receipts from the sale to only £380mio. The buyers will be subject to decommissioning costs, which are estimated to be £1bn net of deferred tax. The Norwegian Spirit Energy business was the source of 92% of Spirit Energy's oil production (12.25mmboe) and 38% of its natural gas production (484mmth), with Centrica having a 69% share of it. If natural gas prices remain elevated, above 145.8 GBp per therm in 2021 and above 96.9 GBp per therm in 2022, Centrica will receive a contingent consideration payment shortly after each relevant period. For the last three months of this year, this will result in around 50 GBp for 121mmth, which makes around £42mio given Centrica's 69% share. For 2022 a similar payment for the whole year could be expected, which would amount to around £168mio.

[1] https://www.centrica.com/media/5348/proposed-sale-of-spirit-energy-s-norwegian-assets.pdf

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Changing cash outflows

Overall, this deal seems fair, as losing this year-to-day cash flows and keeping the hedging losses is roughly offset by the contingent payments for gas prices above the relevant floor. The good news is that Centrica keeps their Spirit Energy UK and Netherlands business, which they plan to run down, by reducing capital expenditures and ensuring pre-tax decommissioning liabilities of £1.2bn (post-tax £0.8bn) are 1.5 times covered. This means that future cash flows will remain in Spirit Energy and not be paid out to Centrica unless the hurdle is covered. The reduced capex will lead to a 10% annual decline in production and reserves are set to be exhausted in around 10 years. Centrica now has over £4bn in cash and once the pension deficit payment is agreed (likely around or below £1.5bn), the company still has well over £2.5bn to reduce their £3.5bn debt load, which could decrease their annual interest payment of £185mio. At the same time, Centrica will increase renewable capex to £100mio annually by investing in solar and battery storage. Centrica's cash outflows will materially improve, as per below (prudently assuming Centrica repays upcoming bond maturities (£300mio in 2022 and £233mio in 2023), but not redeeming bonds early):

Centrica Cash Outflows

Cash Outflows	2021	2022	2023
Capex	£400mio	£150mio	£10-50mio
Pension Deficit	£175mio	-	-
Interest Expense	£185mio	£165mio	£155mio
Renewable capex	-	£100mio	£100mio
Sum	£760mio	£415mio	£305mio

Source: Centrica

How to deploy the excess cash

In the summer of 2021, Centrica's CEO Chris O'Shea suggested to transform their Rough producing asset into a hydrogen storage facility, which he estimated to cost around £1.5bn back then. £800mio of this cost was due to fill up the facility with cushion gas, £300mio to put steel out of holes, steel construction and £400mio for the processing kit. Forward gas prices have meanwhile doubled, which would increase the costs by over 50% and are hence not a viable option unless gas prices come down.

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Redeeming debt early is relatively expensive, and this gives room to pay cash out to shareholders.

At the same time, given the failures of so many energy suppliers in the UK, Ofgem hinted at introducing capital requirements, which could lead to a good portion of the remaining £2.5bn being locked up. On a positive note, given Centrica's strong cash position and the looming capital requirements, the government might be inclined to hand over Bulb Energy's 1.6mio customers to Centrica, putting the company on track of their turnaround.

However, with a market cap of £4bn, we are approaching my first target of £4.5bn and the takeover of Bulb Energy's customers could lift the share price towards this target. At this stage, I would look to cut the position and seek other opportunities that could provide better near term returns.

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