EnQuest: Rising oil prices boost debt reduction

Company:	EnQuest (ENQ LN)	**Market Cap:**	$318mio
Industry:	Oil producer	**Net Debt:**	$615mio*
Country:	UK	**Revenue:**	$1.4bn
Date:	12th September 2023	**Net Income:**	-
Dividend:	-	**Free cash flow:**	$232mio (73%)
Entry:	$318mio	**Target:**	$500mio (+57%)

*at $85/bbl and 45k bopd production

Why EnQuest?

- Pure oil producer with a focus on de-levering the balance sheet, offering high potential upside
- Leading $2.3bn tax losses offer opportunities in M&A with an additional $1.5bn tax loss asset coming available from 2025
- OPEC report points to 3mio bopd deficit in Q4 2023
- US oil inventory drawdowns in recent weeks are one of the largest in history (5.5% in 3 months)
- Energy Security Investment Mechanism, which disapplies the Energy Profits Levy at $71.4/bbl and 54p/therm for 6 months, is being reviewed

About EnQuest

EnQuest is one of the top 4 listed UK North Sea focused oil and gas producers (others being Harbour Energy, Ithaca and Serica Energy), but the only one focused solely on oil with around 45k bopd production, of which 82% is from the UK North Sea and the remainder from Malaysia, including 660 boepd gas. What makes EnQuest stand out are the massive tax losses of $2.3bn + additional $1.5bn coming from Bentley asset available from 2025, which can be used against the oil and gas Corporate Tax (CT) rate of 30% and the Supplementary Charge Tax (SCT) of 10% (but not against the Energy Profits Levy (EPL)). This enables EnQuest to engage in M&A activity with special arrangements, such as paying very little upfront and paying deferred an amount that can be generated from the asset that was bought. The company has made

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strides in de-levering over the last year and further debt reduction is in sight, potentially offering shareholder returns. Importantly, for the first time over the last few years, EnQuest is unhedged to the upside of oil prices by only having purchased far out of the money put options.

EnQuest: Producing assets

Production asset	Barrels of oil per day
Kraken	13,082
Magnus	16,530
Golden eagle	4,545
Other	3,105
Malaysia	8,218

Source: EnQuest

EnQuest: 2023 Free Cash Flow at 45k bopd and $85/bbl

2023	CT	SCT	EPL
$m	30%	10%	35%
Revenue	1,396	1,396	1,396
Hedging	(233)	(233)	(233)
Opex	(425)	(425)	(425)
Capex	(160)	(160)	(160)
Decom	(60)	(60)	
Interest	(100)	(100)	
Tax losses	(420)	(315)	
Investment allowance		(100.0)	(46.4)
Taxable profits	(2)	3.5	532.1
2023 Tax charge	**(0)**	**0.3**	**186.2**

	FCF
	232

CT = Corporate Tax

SCT = Supplementary Charge Tax

EPL = Energy Profits Levy

Source: EnQuest

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Tax situation in the UK

The EPL, which is set to expire in 2028, has resulted in £ billions of revenue for the UK government, but ultimately is leading to lower production and capital spending abandonment. Usually, oil and gas companies pay taxes in January, July and October, however, due to the massive tax losses, EnQuest is only having to pay the EPL in October, which will be $75mio for last year's EPL. The amount is lower than expected due to an overpayment made last year of over $35mio and the implementation of the EPL only since 24th May from last year, i.e. not a full year, while next year, the EPL will nearly cut free cash flow (FCF) in half – this is despite saving the CT and SCT. The key to EnQuest in comparison to other UK North Sea oil and gas producers is that their tax losses are by far the largest, and hence will last for many years to come, and they are all in the same entity. Other producers, such as Harbour Energy, will likely have exhausted their tax losses by next year and also has them in different entities, hence still needs to pay some CT and SCT. In June 2023, the UK government introduced the Energy Security Investment Mechanism (ESIM), which will eliminate the EPL when oil and gas prices have stayed below $71.4/bbl and 54p/therm respectively for two consecutive quarters. This is an extremely unlikely scenario, but from what I hear is that they are reviewing this and it will likely be adjusted for inflation and could allow for some enhanced investment allowance to keep capital spending alive. This could become a game changer, especially when EnQuest manages to get more M&A deals agreed beforehand, as many competitors are exiting the UK amidst the unsustainable tax situation.

Kraken outage a concern?

Kraken used to be their main producing asset, but due to natural decline and an outage, production has declined below that of Magnus. The expected natural decline will be around 15-18% per annum. Kraken is a complicated field, as the long horizontal drilling is complex and for the planned $150-200mio on the West Front a special rig would have been needed. Overall, the economics were less compelling also due to the EPL, which in turn led EnQuest to delay this capex programme by at least one year and instead some sidetrack drilling will be done late 2024 with enhanced production to come online beginning of 2025. This is why there shouldn't be any concern with regards to the Kraken field, and EnQuest will likely succeed in some M&A deals to keep production at least where it is this year.

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Energy transition

EnQuest has a very unique position in the North Sea as the owner of Sullom Voe. This infrastructure can be used to link Carbon Capture Storage (CCS) from land to the underwater deposits, and EnQuest values this opportunity at up to $1bn. The 4 approved carbon capture licenses therefore only need single digit $mio spending, as they will seek partners to pay for the rest and using their existing infrastructure. With 10mio tonnes of CO2 being captured per annum with these 4 projects, at a price of £100 per ton of CO2 tax, this can result in hundreds of £mio worth of savings or tax credits. The company has further plans on electrification and green hydrogen and its derivatives products in the making, which could be clarified at their Capital Markets Day that is set to take place in the next 12 months.

The macro is supportive

OPEC's oil output cuts have certainly helped in recent weeks to reduce US oil inventories. With the cuts being extended all the way to year-end, OPEC expects a 3mio bopd shortfall for Q4 2023[1]. Since the cuts began in June 2023, US oil inventories declined by 42mio barrels in just 3 months (5.5% of inventories). Importantly, in those weeks where the inventories did not decline, net imports were between 3-4.5mio barrels a day. The average net imports during this period amounted to 2.7mio bopd, however. This shows that US oil production needs to climb much more in order to stop oil inventories from declining, as imports cannot sustainably reach 4mio barrels a day in light of the OPEC output cuts and the world economy growing. US production did climb by 500k bopd in August, yet, inventories continued declining nevertheless, indicating just how severe the supply/demand mismatch is.

[1] https://momr.opec.org/pdf-download/ September 2023 report

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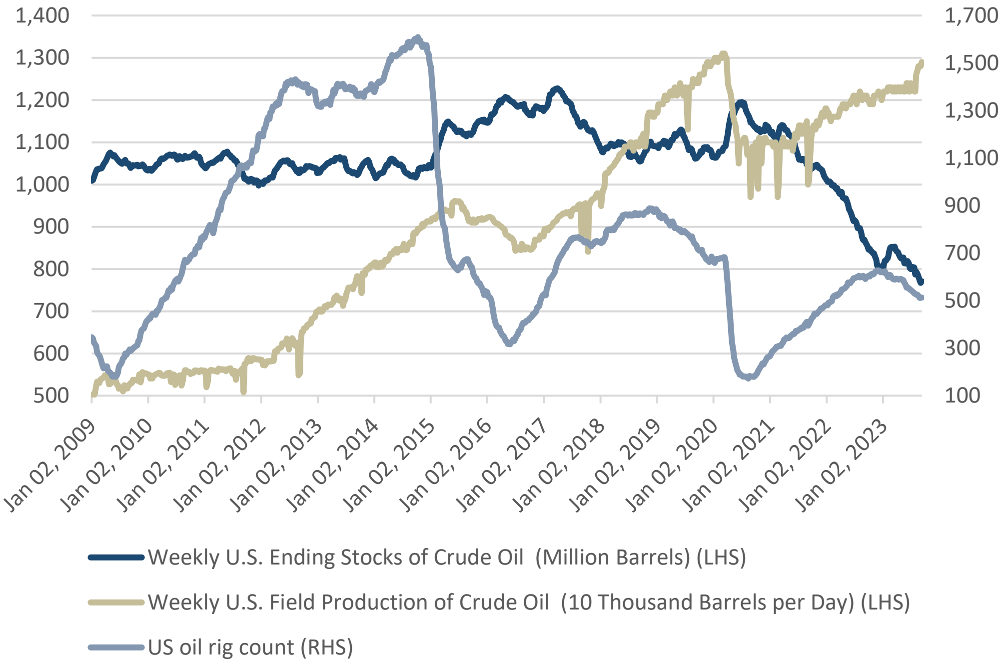
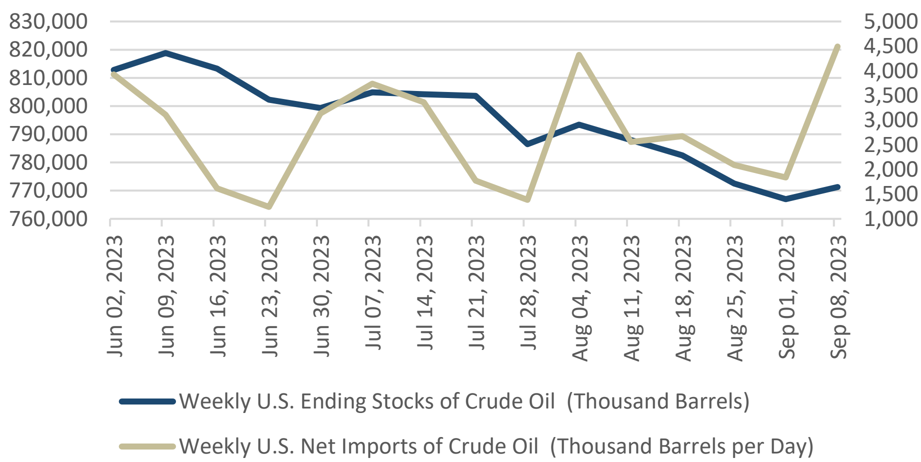
US oil inventories fall to record lows, while production is near record highs and rig count declines



Source: EIA, Baker Hughes

US oil inventory declines can only be averted by higher oil imports



Source: EIA

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