EnQuest: Is the turnaround finally coming?

Company:	EnQuest (ENQ LN)	**Market Cap:**	$538mio
Industry:	Oil Producer	**Net debt:**	$1.28bn
Country:	UK, Malaysia	**Revenue:**	$1.5bn ($75 barrel oil, 55k boepd)
Date:	12th January 2022	**Net Income:**	$140mio ($450mio Depletion) (9%)
Dividend:	-	**Free Cash Flow:**	$600mio (40%)
Entry:	$525mio	**Target market cap:**	$750mio

Introduction

EnQuest is a highly indebted offshore oil producer with licenses in the North Sea and in Malaysia with most of its production coming from the North Sea (>90%). The company focuses on oil fields that have a short remaining life with low operating expenditures and has close to $500mio in tax credits for its North Sea assets. Over the past five years EnQuest was able to reduce its net debt by 35%, while nearly halving its unit operating costs per barrel of oil. Its heavy oil is sometimes sold above Brent Crude and with crude hovering at near $85 a barrel, EnQuest stands to benefit more than other producers from the higher oil price. Below charts demonstrate how EnQuest has developed over the last few years with 2021 and 2022 being estimated by me, as I expect capital expenditures to double in 2022 compared to 2021 and assumed $450mio of depreciation/depletion as well as $75 barrel of oil. Those numbers are a rough guidance and are unlikely to be accurate, especially in light of unknown production and oil prices.

EnQuest Annual Cash Outflows

Expenditure Items	Cash Outflows (in $mio)
Operating expenditures	300
Capex**	250
Short-term debt interest expense	35
PIK interest expense	95
Kraken lease	115
Golden Eagle profit share (>$65 boe)	50
Magnus profit share	70
Total	**915**

**estimated

Source: EnQuest Annual Reports & Trading Updates

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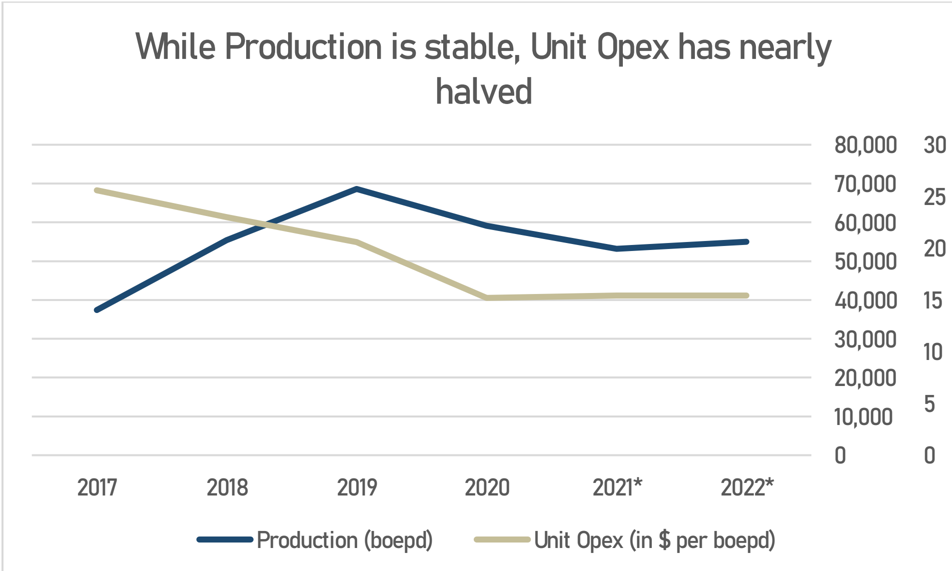
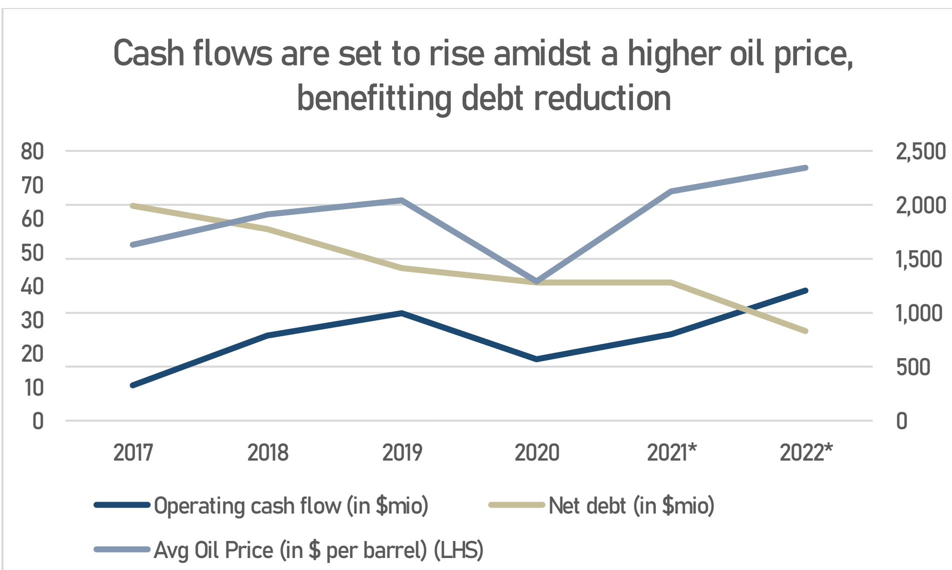


Source: EnQuest Annual Reports & Trading Updates



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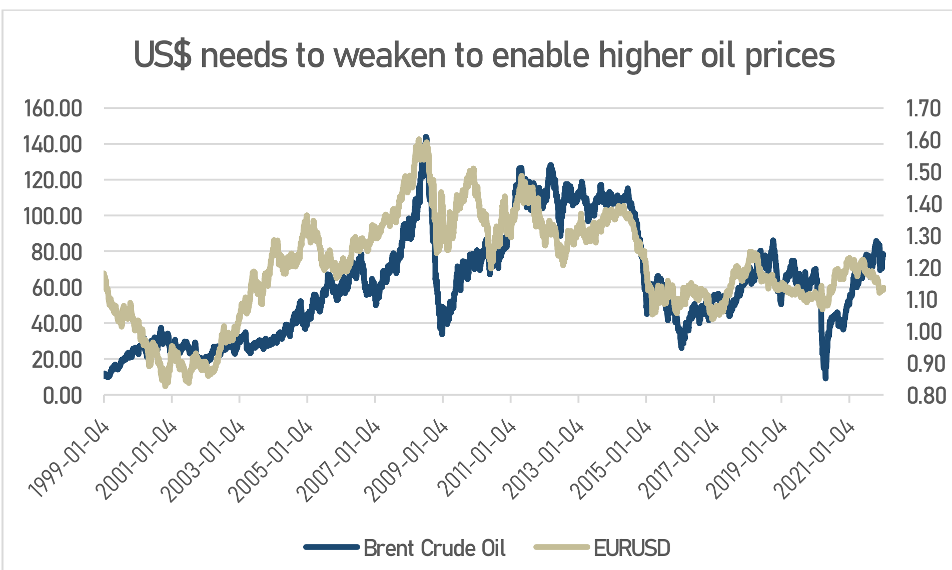
Why so cheap?

EnQuest has a history of being over indebted, having to issue equity and at times experiencing production issues. This has left bondholders with high returns at the cost of the shareholders. Amid the relatively short life of EnQuest's fields, there is a constant need to buy more licenses and pay for new exploration – in a way that is relatively similar to some of the shale oil producers in the US. In November, the company lost nearly 40% of its market capitalization amid downtime and production issues at their two largest producing assets, Magnus and Kraken.

What is the turnaround?

I have owned EnQuest shares multiple times in the past and each time was able to return 30-40% within a relatively short time frame. The reason for this is that EnQuest is a leveraged bet on oil prices, which are now at multi year highs. Given my view that the 4th wave of Covid (Omicron) is making the virus less deadly, exactly as did the 4th wave of influenza/Spanish Flu in the 1918-20s, I expect a rapid return in movement over this spring & summer with people beginning to fly more often, hence leading to a higher oil price. At the same time, I expect the US$ to weaken, as a weaker virus benefits emerging markets and the more lockdown prone European countries, hence leading to capital inflows into these regions and outflows from Tech/Nasdaq. A weaker US$ and higher movement at a time of relatively lower investment in oil & gas could therefore lead to a spike in oil prices, which we have seen in 2008 the last time upwards of $150 a barrel.



Source: FRED St. Louis

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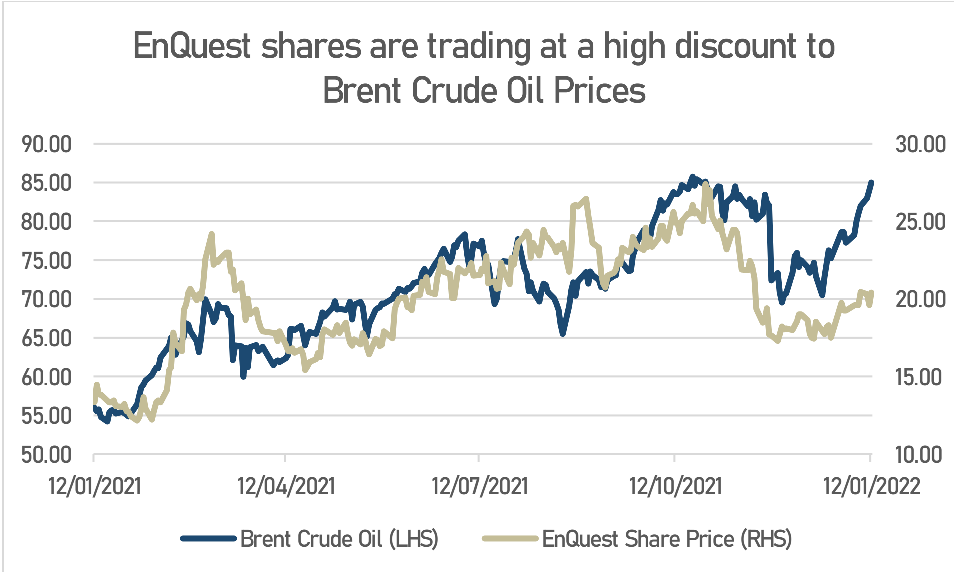

Source: FRED St. Louis, Yahoo Finance

While my view of $150 barrel oil is highly speculative, the fundamentals of EnQuest are less so. Given the debt reduction and the likely temporary production outage of late 2021, EnQuest's valuation needs to adjust higher, closer towards $85 barrel oil equivalent. However, EnQuest's market capitalization remains below pre-pandemic times despite higher profit margins, lower debt and higher oil prices. At the beginning of February 2022, the firm will present its 2022 guidance, and while I doubled capital expenditures, they might even triple due to the low figures during the pandemic and resulting lower production. For this reason, I am careful in holding shares on the announcement – although a tripling of capital expenditures would not matter, if oil prices are above $100 a barrel. For the time being, EnQuest is on its turnaround and shares need to reprice in light of higher crude oil prices.

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