Harbour Energy: The energy crisis is not over yet

Company:	Harbour Energy (HBR LN)	**Market Cap:**	$3.25bn
Industry:	Oil & gas producer	**Net Debt:**	$1.1bn
Country:	UK, worldwide	**Revenue:**	$5.5bn*
Date:	5th December 2022	**Net Income:**	$1.4bn (25%)
Dividend:	$400mio share buyback (12.2%) $200mio dividend (6.1%)	**Free Cash Flow:**	$2bn (36%)
Entry:	$3.33bn	**Target Market Cap:**	$5bn

*post-hedging oil price $80/bbl and gas price 86p/therm

Introduction

Harbour Energy is the UK's largest oil and gas producer with 207k boepd (51% oil, 49% gas), of which over 90% is produced in the UK. Outside of the UK, the group owns assets in Norway, Mexico, Indonesia and Vietnam and has nearly 1bn barrels of oil equivalent 2P (50%) + 2C (50%) reserves vs. 75.5mio boe annual production. As of November 2022, Harbour was hedged for roughly 45% of its production for 2023 at $74/bbl oil and 42p/therm gas vs. $61/bbl oil and 46p/therm gas in 2022. The hedges start improving from 2024 at $84/bbl oil and 79p/therm gas with ¼ of the production hedged so far. The company was founded by private equity and evolved through acquisitions from majors with first 17k boepd production through a transaction with Shell in Q4 2017, then to 137k boepd through a transaction with ConocoPhilips in Q3 2019 and finally 175k boepd through a merger with Premier Oil in Q1 2021 before increasing production organically to 207k boepd this year.

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The downfall in Harbour Energy's market valuation

To some degree the decline in gas prices and to another the increase in the UK Energy Levy from 25% giving all-in tax rate 65% as of H1 22 to 35% with an all-in tax rate of 75% from January 2023 has reduced Harbour Energy's market cap by over 35% in just two months from over $5bn to only $3.3bn. The additional 10% increase in the UK Energy Levy from next year is particularly painful due to the 80% investment allowance being reduced to 29% for fossil fuels in a drive to shift producers towards renewables, which will maintain the 80% investment allowance. This will keep the absolute $ allowance equal to the 25% Energy Levy, but will add 10% tax in full on top[1]. However, running a very pessimistic but possibly realistic scenario of oil and gas prices, costs and capex next year, Harbour Energy would still make over $400mio in net income. In this scenario, I assume depreciation = capital investment & decommissioning of around $1.5bn, slightly higher overall costs of around $3bn a year (including depreciation) and relatively low oil prices of $70/bbl and 100p/therm gas prices. The 65% tax rate takes into account the lower tax rates of the 10% production outside of the UK and is trying to integrate the 29% investment allowance (wrong from an accounting point of view, but should provide a rough ballpark figure to be comfortable with).

Harbour Energy's 2023 profit estimates under prudent assumptions of $70/bbl and 100p/therm

Category	Daily production in bbl	Yearly production in bbl	$/bbl or p/therm	Revenue in $
Oil	105,570	38,533,050	71	**2,741,113,500**
Oil hedged	30,000	10,950,000	74	810,300,000
Oil non-hedged	75,570	27,583,050	70	1,930,813,500
Gas	101,430	37,021,950	64	**1,672,451,518**
Gas hedged	63,233	23,080,000	42	685,919,136
Gas non-hedged	38,197	13,941,950	100	986,532,382

COGS	Operating Profit	Finance expense	Pre-tax profit	Profit after 65% tax
3,000,000,000	1,413,565,018	100,000,000	1,313,565,018	459,747,756

Source: Harbour Energy, own estimates

[1] https://www.gov.uk/government/publications/autumn-statement-2022-energy-taxes-factsheet/energy-taxes-factsheet

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How does Harbour Energy's valuation compare to competitors?

Harbour Energy has by far the worst executed hedges in place compared to its competitors in the North Sea. This is the main reason why Harbour trades with such a discount in comparison to the others. However, the discount is too deep, in my opinion. Italian oil and gas producer Eni is in talks to take over Neptune Energy (130k to 165k boepd) for $5-6bn[2]. Norwegian oil and gas producer Var Energi (220k boepd with >350k boepd from 2025 target) is currently valued at $9bn, while Ithaca Energy (77k boepd) is valued at $2.2bn (all producers have roughly the same $1bn net debt currently). The $3.3bn valuation of Harbour Energy therefore looks attractive, especially as a takeover target where you would value the company on a more long-term basis.

Valuation comparison of Harbour Energy vs. competitors

Company	2023 expected production	Oil/Gas split in %	Oil/gas hedges in $/bbl and p/therm for 2023	2022 post tax FCF	Credit rating	Valuation
Harbour Energy	207k boepd	51/49	74/42	$2bn	BB	$3.3bn
Neptune Energy	165k boepd	26/74	48-117/61-181	$2.5bn	BB+	$5-6bn
Var Energi	220k boepd	57/43	25k bopd put option @$47	$3bn	BBB	$9bn
Ithaca Energy	77k boepd	62/38	68/200	$1.2bn	B	$2.2bn

Source: Harbour Energy, Neptune Energy, Var Energi, Ithaca Energy

The macro energy outlook

As a recession is looming and Europe having cut 25% of their gas consumption this year[3], there is a legitimate question whether oil and gas prices will fall next year, especially as we have seen deflation occurring in many other parts of the economy such as in freight, house prices, wheat, cotton, copper, iron ore and even oil to some degree. However, the recent rise in UK gas prices might last longer due to extremely cold weather[4] and relatively low winds[5] (snow cover is at a 56 year high for this time of the year!). European gas storage withdrawal levels have picked up in recent days, but remain at higher levels only when compared to 2018 and 2019, with the latter having had similarly strong overall storage levels.

[2] https://www.reuters.com/markets/deals/eni-preliminary-talks-buy-neptune-energy-5-6-bln-source-2022-11-30/
[3] https://www.ft.com/content/0ab21afc-d034-4279-8ce1-4469d0ce8489
[4] https://www.severe-weather.eu/global-weather/sea-ice-snow-extent-northern-hemisphere-grow-winter-rrc/
[5] https://windy.app/forecast2/spot/685582/North+Sea

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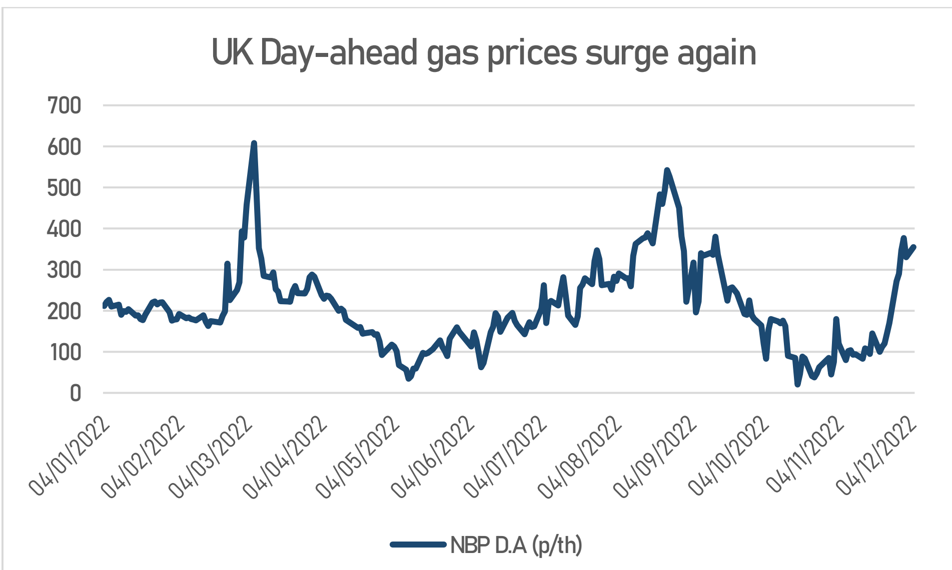
In 2019/20 Europe also had over 60% of gas in storage by the end of February – this should be kept in mind given that storage levels at most similar to 2019 currently and Germany is targeting 40% gas in storage by end of February. At the same time, the recent reopening of China's economy and move away from the zero Covid policy as well as the low US SPR levels, which are said to be refilled at $70/bbl, should be supportive for oil prices as well as gas prices (although the ending of zero Covid policy could be chaotic in the near-term). The big unknown will likely be the $60 price cap of Russian oil and the sanctions on Russian oil shipment insurance. While Russia has amassed more than 103 ageing tankers to circumvent these sanctions[6], this still falls short of the 175 tankers Braemar Shipping expects Russia needs to circumvent these sanctions completely[7]. If Russia would trade under the price cap of $60/bbl, current insurance cover would cost $20/bbl alone according to shipbrokers[8]. Russia will likely retaliate, and this could move oil prices to the upside… Interestingly, price action in oil and the $ has been moving in inverse correlation to US economic data in recent days, as a more restrictive Fed is expected by the market. While this calls for caution, the current valuation of Harbour Energy makes it a good investment when compared to its competitors.



Source: Zenergi

[6] https://www.ft.com/content/cdef936b-852e-43d8-ae55-33bcbbb82eb6
[7] https://lloydslist.maritimeintelligence.informa.com/LL1142759/Sanctioned-Russia-faces-tanker-tonnage-shortfall-for-oil-export-logistics
[8] https://www.rigzone.com/news/shipping_costs_for_russian_oil_soar-2-dec-2022-171242-article/?utm_campaign=DST_DAILY_EDI_FEATURED_1&utm_source=GLOBAL_ENG&utm_medium=EM_NW

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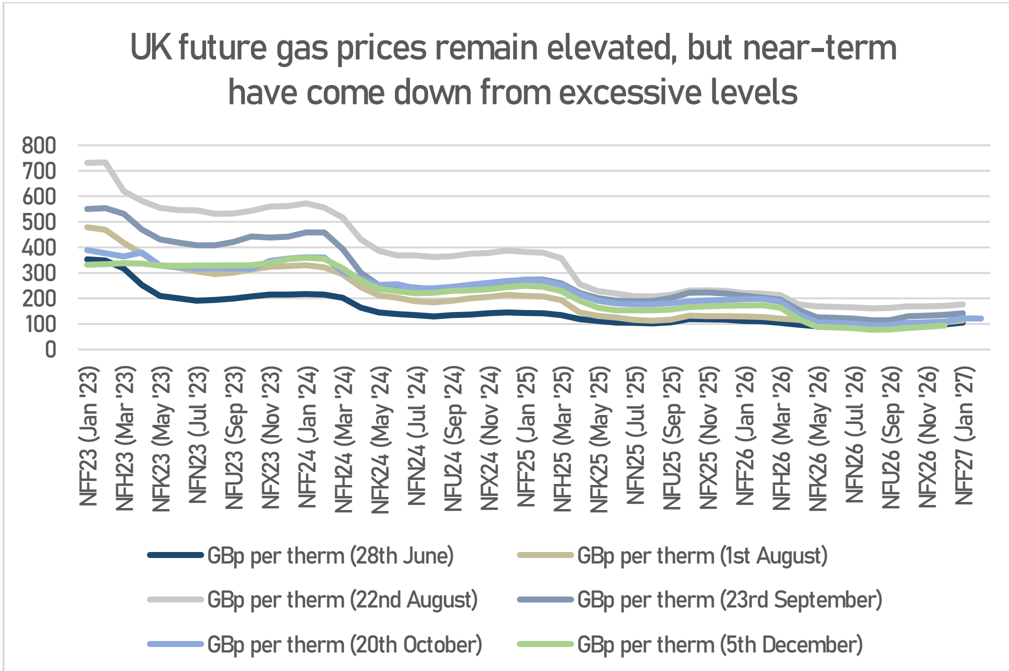
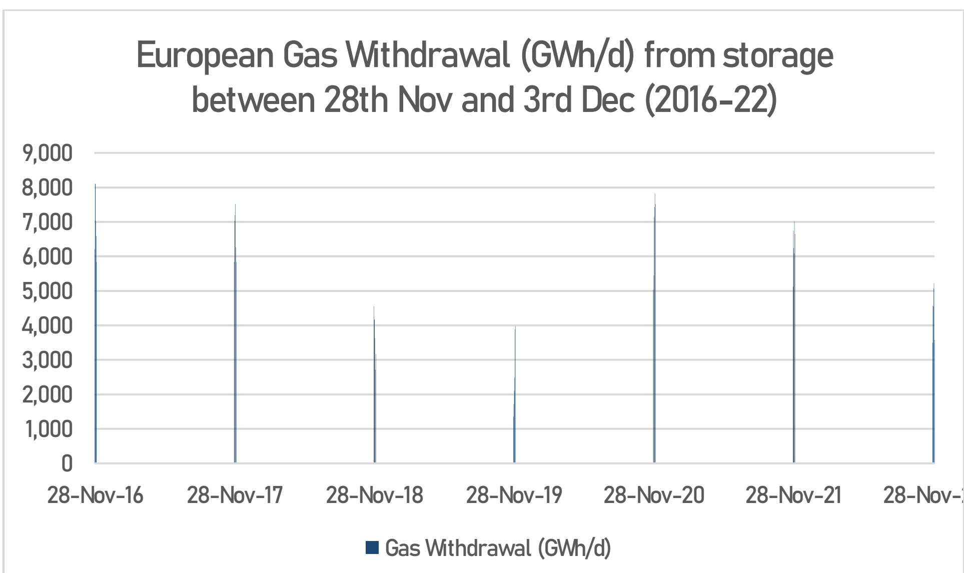


Source: Barchart



Source: AGSI

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European gas storage tanks are lower than in 2019 during this time of the year

3rd December	Storage tanks full %
03/12/2016	78
03/12/2017	78
03/12/2018	80
03/12/2019	94
03/12/2020	86
03/12/2021	66
03/12/2022	92

Source: AGSI

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