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Update Serica Energy: Day-ahead gas price back at invasion levels

Company:	Serica Energy (SQZ LN)	**Market Cap:**	£1bn
Industry:	Oil & Gas	**Net Cash:**	£83mio + £278mio pledged for margins
Country:	UK	**Revenue:**	£1.1bn
Date:	3rd August 2022	**Net Income:**	£460mio (41%)*
Dividend:	3%	**Free Cash Flow:**	£520mio (35%)
Entry:	£817mio	**Target Market Cap:**	£1.2bn

*numbers assume 26.832k boepd production, GBp 180 per therm (gas), $100 a barrel (oil), 40-65% tax rate

Profits on track to exceed £400mio

With day-ahead prices recovering to a high of GBp 300 per therm, Serica Energy's profits are recovering back towards Ukraine invasion levels. YTD Serica was able to sell gas at an average level of GBp 180 per therm and oil at $107 per barrel, which would generate annualized profits after hedging losses (£150mio) and after taxes (40% until end of May, 65% from end of May incl. 91.25% tax savings on £60mio exploration costs) of £460mio. For next year, if prices realized at current forward prices, net profits could even rise to over £650mio in net profits. I estimate the net cash figure to move to £650mio (after 9 pence dividend and taxes paid) by end of this year – this compares to a market cap of around £1bn as of beginning of August, which would give Serica an end of year enterprise value of £350mio.

Serica Energy fundamentals for 2022 year-end at 26,832 BOEPD (85% gas)

Serica Energy	in £mio
Gas revenue @180p/th	1020
Oil revenue @$100/b	120
Fixed costs	-150
Hedging losses @180p/th	-150
Exploration costs	-60
Taxes	-320
Net income	460
Net cash end of December 22	650
Market cap August 1st	1000

Source: Serica Energy, own estimates (annualized)

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Kistos merger proposal

Kistos, the Dutch North Sea gas producer, has approached Serica Energy for a merger proposal in May and published their offer mid-July[1], with a revised offer end of July[2]. While the revised offer values Serica Energy at GBp 425 a share (£1.25bn), the cash components of the offer would actually be paid with Serica's own cash and the revised offer only took advantage of the higher share price of Kistos, in which Serica shareholders would receive 0.4 Kistos shares per Serica Energy share and hold 58% of the new company. Although the offer reached my target valuation of £1.2bn, Serica's board rejected the offer in advance, which I believe is correct, since the actual valuation of the deal is more around £820mio taking into account that the 146 pence cash consideration to be paid from Serica Energy cash resources. The valuation of Kistos is also overvalued when compared to Serica (although European natural gas prices are slightly higher than UK's, Kistos has no hedges in place and taxes are lower in the Netherlands). Nonetheless, I do approve on the combination of the two companies and hope they can find a solution in terms of price.

Serica Energy vs. Kistos comparison

As of 1st August	Serica Energy	Kistos
Market cap	1000	435
Enterprise value	612	430
2021 EBITDA	387	67
2021 net income	79	-62
2021 Oil production	4.2 boepd	-
2021 Gas production	17.8k boepd	5.3k boepd
Combined production	22k boepd	5.3k boepd
2022 Oil production	4.2k boepd	3.2k boepd
2022 Gas production	23.4k boepd	12k boepd
Combined production	28k boepd	15.2k boepd
Reserves	62.2mio boe	18.1mio boe
Potential reserves	124mio boe	24.3mio boe

Source: Serica Energy, Kistos

[1] https://www.serica-energy.com/combination/12%20July%202022%20-%20Kistos%20plc%20possible%20offer%20announcement.pdf
[2] https://www.serica-energy.com/combination/Kistos%20PLC%20-%20Proposed%20Combination%20-%20Revised%20Terms.pdf

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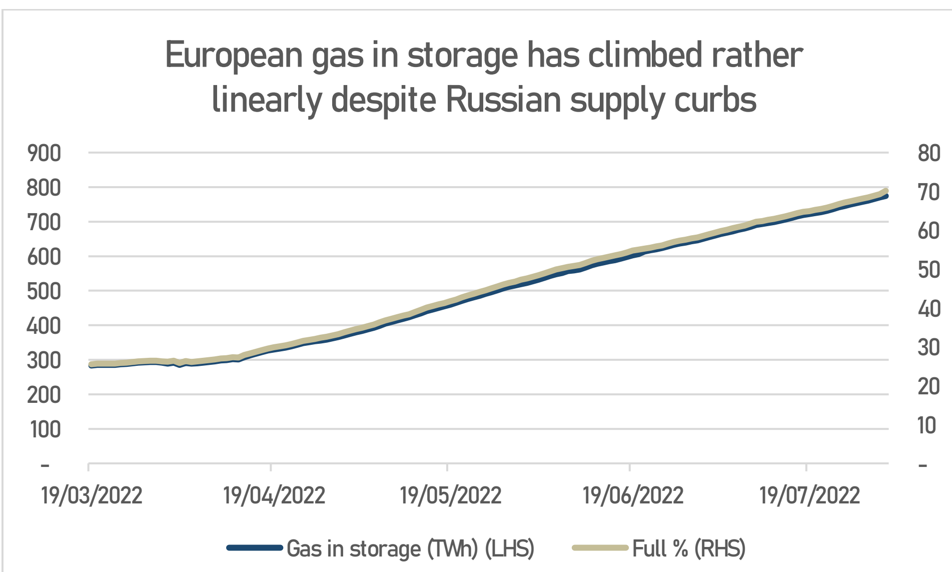
European gas in storage is climbing rather fast

Despite a potential enterprise value of just £350mio, which would be well below net profits achievable at current forward gas prices, and a doubling of 2P reserves, if the exploration in North Eigg is successful in October, I began considering to sell Serica Energy when the valuation exceeded £1bn market cap. This is because the European gas in storage levels keep surprising me. When Nordstream I was shut down for maintenance, gas in storage began to dwindle or at least climb too slowly to achieve 80-90% storage levels by November. However, even at current 20% Nordstream I flows (0.36 TWh of 1.8 TWh capacity), gas in storage is climbing at over 4 TWh a day and would achieve 98% storage levels by 10th October at this pace (after 10th October storage levels generally stop climbing before they start drawing from beginning of November). This in combination with demand destruction actually points to Europe succeeding in the gas game. Russia, on the other hand, unlikely will turn off the taps completely, as they need revenues to continue the war in Ukraine. Therefore, I am cautious and might sell the position over the next few days/weeks.



Source: AGSI

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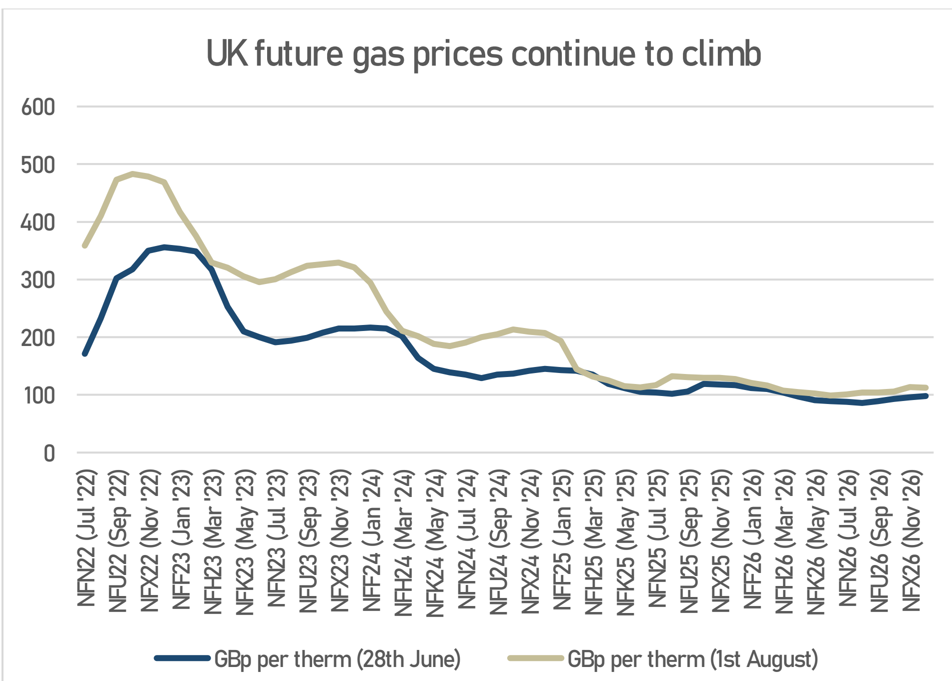
Gas forward prices might have peaked

I believe the gas forward market could have peaked here and is generally more driven by buyers than sellers currently. This is because most gas producers are hedged to a large degree at very low prices (Serica 20%, Harbour Energy >50%) and therefore need to post a lot of cash as margin. During the height of the Ukraine invasion this almost caused for companies to go bankrupt amidst the margin calls. At current forward prices I estimate Serica Energy's cash requirement for margins to be around £278mio. Given that Serica paid a dividend of around £25mio, spends around £60mio on exploration and had net cash of £396mio as of 6th June, by beginning of August Serica is expected to have generated around £50mio in additional cash, which would bring their net cash after margin payments to only £83mio. I have asked the management to hedge more production at these excessive forward prices, but they have experienced a near death penalty over margin payments in March and hence do not want to play with fire here. This makes sense, as another spike in forward prices could leave additionally hedged volume temporarily under water and cause additional margin calls. Once these hedges come off, however, gas producers will start locking in their production at forward prices again and this could improve the balance of forward gas price buyers vs. sellers.



Source: Barchart

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Serica Energy hedging costs at current gas futures (3rd August 2022)

Quarter	Average price p/th	Current futures price p/th	Production th/d (in mio)	Hedged volume as of August 1st (in mio)	Margin payments (in mio)	Revenues (180p/th) (in mio)
Q3 22	41.8	396	1.5	18	-64	162
Q4 22	47	474	1.5	23	-96	243
Q1 23	55.6	483	1.5	18	-77	243
Q2 23	42.2	363	1.5	9	-29	243
Q3 23	40.7	324	1.5	5	-13	243
Q4 23	-	343	1.5			
Total					**-278**	**1,134**

Source: Serica Energy

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