Serica Energy: A profit-making machine

Company:	Serica Energy (SQZ LN)	**Market Cap:**	£800mio
Industry:	Oil & Gas	**Net Cash:**	£246mio + £150mio pledged for margins
Country:	UK	**Revenue:**	£830mio
Date:	29th June 2022	**Net Income:**	£250mio (30%)*
Dividend:	3%	**Free Cash Flow:**	£290mio (35%)
Entry:	£817mio	**Target Market Cap:**	£1.2bn

*numbers assume 26k boepd production, GBp 150 per therm (gas), $110 a barrel (oil), 50% tax rate

Introduction

Serica Energy is an oil & gas upstream production firm with operations located in the North Sea. The company guides to produce between 26k – 30k boepd with 85% of the volume being natural gas and the rest oil. Serica currently has three major fields in production, namely BKR (consisting of Bruce, Keith and Rhum fields, net 20k boepd, 100% Serica), Erskine (net 1.5k boepd, 18% Serica) and Columbus (net >4.5k boepd, 50% Serica) carrying around 62mio boe in reserves, which at current production would last 6.5 years. The reserves have been stable over the last few years, as field enhancements and new discoveries offset extraction. This year Serica is spending £15mio on the BKR field to enhance current production profiles and increase field life and £45mio on exploring the North Eigg prospect (estimated 60mio boe P50 reserves, 100% Serica) to be started in July 2022. When the Columbus well was spudded last year, it took around 8 months until production started. Decommissioning liabilities are minimal with <£30mio due to most liabilities being paid by previous operators. Serica has hedged 20% of production forward when gas prices were still low and therefore carries some margin payment risks whenever there are spikes in natural gas prices (currently £150mio). These hedges have come off to a large degree and will vanish by Q3 2023. Due to the risks of more cash being caught up in margin payments, the company currently sells 80% of their gas at day-ahead prices, which are generally lower and have averaged GBp 186 per therm over the first five months of 2022 (current forward gas prices for the winter 22/23 are as high as GBp 350 per therm).

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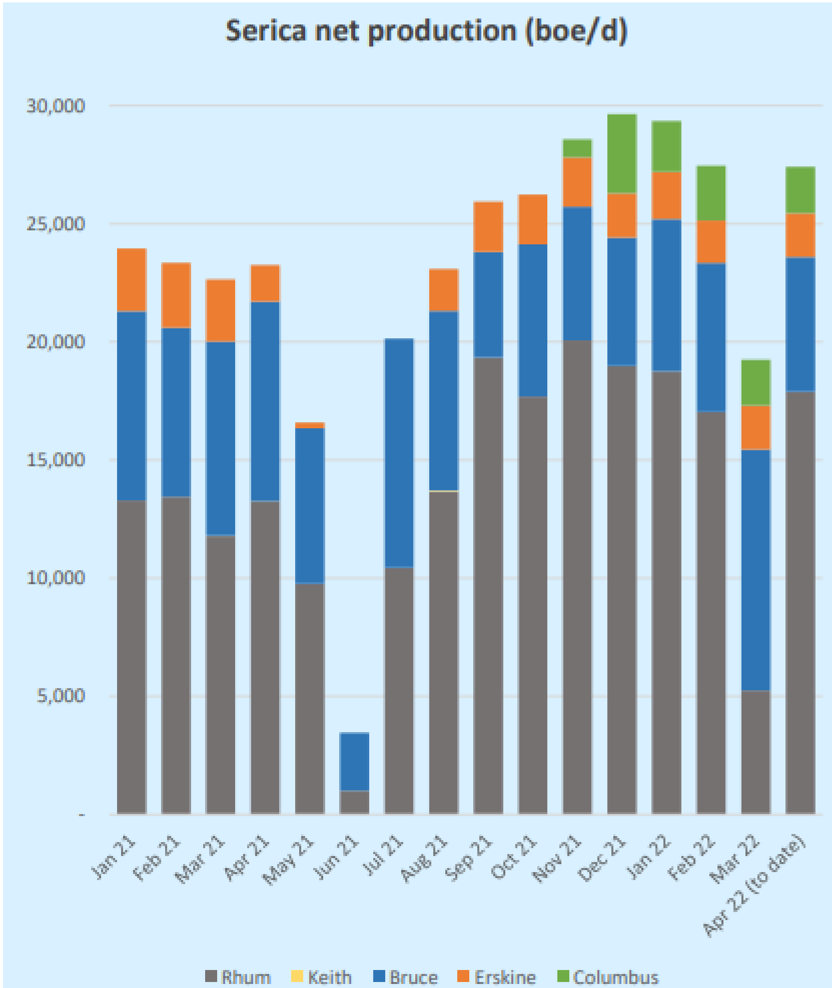

Source: Serica Energy FY 22 Presentation

A simple, yet vulnerable business

Serica Energy is a very straight-forward oil & gas producer that fully depends on where day-ahead gas prices and spot Brent crude prices trade. While key is to keep outages to a minimum, due to the reliance on the BKR fields, an extended outage poses the biggest risk to Serica next to a collapse in oil and especially gas prices. A combination of an unplanned outage of the highest producing field, Rhum, in March and the UK Energy Profits Levy has reduced Serica's valuation drastically from £1.15bn to £800mio. However, the enterprise value has declined to just £400mio while exploration capex coming into force after the Energy Profits Levy began, the tax bill for this year will likely be mostly spared from the additional 25%. Assuming a conservative GBp 100 per therm and $100 a barrel with 26k boepd production & £60mio capex as well as a 65% tax rate (+ taking into account the hedge losses), next year Serica would still make over £150mio

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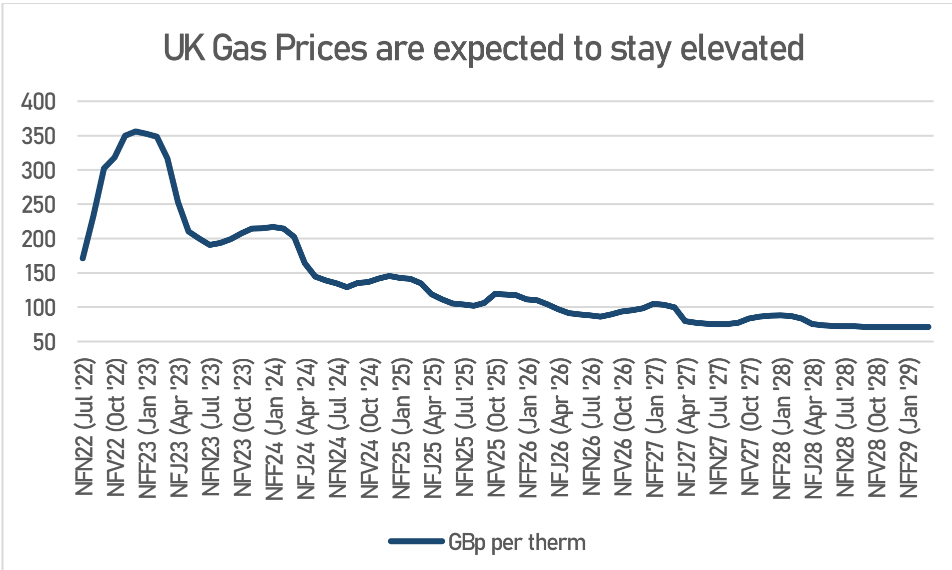
in net profits (=2.6 enterprise value/net income). The futures curve is currently pricing an average of GBp 241 per therm for 2023, which, if realized, would create £412mio in net profits, exceeding Serica's enterprise value. This is again taking into account a 65% tax rate.



Source: Barchart

Hedging risks

Serica has on average around 14% of gas production hedged over the next year. These hedges were executed before mid-2021 and therefore executed at much lower prices. This in turn has caused margin calls of around £150mio, which restricts a good amount of their cash and is the reason they have not hedged further flows. However, 14% is a small amount compared to larger producers in the North Sea, such as Harbour Energy, which have hedged nearly 80% of their gas production for 2023 at low levels, or EnQuest, which have hedged around half of their oil production for 2022 at low levels. I am currently trying to get Serica's management to start hedging around 300,000 therms/day for 2023, while seeking an RCF with a bank to enable liquidity, if gas prices were to spike again. During the height of the Ukraine invasion, gas prices peaked at around 600 pence/therm. Hedging 300,000 therm/day for 2023 at 241 pence/therm would require £400mio in margin pledges, if gas prices were to spike to 600 pence/therm again & £830mio at 1,000 pence/therm. For the former case, Serica has enough liquidity, and for the latter

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they could sign an RCF to enable liquidity, if such a dramatic case would occur – unlikely, as multiple utilities would be unable to manage their margin payments.

Serica Energy hedged gas production

Quarter	Weighted average price hedged p/th	Volume of gas hedged th/d	Current futures price p/th	Expected gas production th/d
Q3 22	41.8	300,000	246	1,500,000
Q4 22	47	250,000	342	1,500,000
Q1 23	55.6	200,000	337	1,500,000
Q2 23	42.2	100,000	221	1,500,000
Q3 23	40.7	50,000	194	1,500,000
Q4 23	-	-	212	1,500,000

Source: Serica Energy, Barchart

A clown's show

Watching some excerpts of the G7 meeting in Germany earlier this week (here, here & here), gives little confidence in a solution of the energy crisis, let alone the end of the war in Ukraine and defeating Putin. The price caps for Russian gas are unlikely to come into effect, as the Kremlin already said that Gazprom would revise the contractual terms, if the proposals come into force, i.e. shut down gas supply to Europe. Europe is more confident in applying the crude oil price cap on Russia, as Russian oil is already diverted to China and India, giving Europe the chance to substitute their oil demand with other sources. This, however, is not possible with gas due to infrastructure (most supply comes via pipelines, which cannot be diverted to China and India). As laid out in How to master the Putin Energy Game & Can the EU wean itself off Russian energy?, total gas consumption in Europe is around 5,322 TWh of which over 40% is imported from Russia. Germany's economy minister Habeck gave a dramatic speech ahead of the G7 meeting, calling for an 8% reduction in German industry gas demand, 15% reduction in household gas demand and warned of a Lehman Brothers moment in energy markets, if Nordstream gas flows would reduce to zero. Habeck expects gas prices to treble in such a scenario and would lift the price regulated utility market, passing on high prices to consumers to avoid widespread failures in the energy market. The IEA meanwhile posted that Europe needs to be ready to cut gas use by 30% in the winter. The UK is not immune from Russian gas supply shocks, as although the UK stopped Russian LNG imports since 2nd March 2022 (6% of imports), 9% of gas imports are from Belgium and the Netherlands, i.e. from Russia as well. While there is a chance of fracking becoming legal in the UK (expected decision by end of June), higher coal production

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and a massive gas field discovered in Algeria that is expected to produce before the end of the year (39 TWh per annum)[1], Putin will play his cards well and squeeze the market to maximize profits and there is only one thing we can do: Increase domestic gas supply – which is being done too late, too little and too slowly…

[1] https://www.rigzone.com/news/sonatrach_makes_massive_gas_find_in_sahara_desert-28-jun-2022-169494-article/?utm_campaign=DAILY_2022_06_28&utm_source=GLOBAL_ENG&utm_medium=EM_NW_F3

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