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EnQuest PLC

market cap: £381m /   ticker: ENQLN

Oil has recovered since its late December lows, but the significant price fall in the final quarter of 2018 from 86$ per barrel to $60 today has brought the oil sector back into focus.

EnQuest is one several smaller operators that we have tracked over the past five years. While the group has made substantial progress boosting production and cutting costs during this period, the group remains highly levered. Consequently, both the stock and bonds remain sensitive to any fluctuations in the price of oil.

Details of the group's USD and the GBP deals are outlined below. Following a recovery in recent days, both securities are trading circa 13 points below October levels:-

Issuing entity	ISIN	Coupon	Currency	Maturity	Rating		Amount Outstanding	Days Accrued	Price at 31.10.18	Offer Price	YTM
ENQUEST PLC	XS1517932585	7.00%	USD	15/04/2022	B-		$746,056,250	58	91	77.5*	16.95%
ENQUEST PLC	XS0880578728	7.00%	GBP	15/04/2022		B3	£171,851,270	118	95	82*	15.36%

** Both bonds trade dirty currently (ie inclusive of accrued)*

Oil's last major correction occurred in 2014; Brent crude fell from $114/barrel in June 2014 to a low of $28/Barrel in January 2016. As we approach the five-year anniversary of that last major bear market for oil, we look at how EnQuest has changed during the intervening period.

Production

In H1 2014 EnQuest produced 25,292 Boepd. By H1 2018, this figure had more than doubled to 53,990 Boepd. For the full year 2018, the group expects output in the 54-56,000 range.

In an early December trading statement, the group indicated that it expects 2019 production to rise 20% to 63,000-70,000 driven by the Magnus transaction (discussed later) although we are expecting fresh guidance in a trading statement towards the end of January.

Operating costs

EnQuest has also made considerable headway reducing its operating costs with the group's average unit operating cost for production and transport decreasing by circa 50% over the past five years:-

$ per barrel	H1 2014	H1 2018
Tariff / Transportation	10.5	4
Production	35.4	18.6
Total	45.9	22.6

Leverage

EnQuest's debt levels remain elevated; at H1 2018, gross debt totalled $2.16bn, comprising a large term facility (3M USD Libor + 475bps) and $973m of bond debt (7% coupon), of which £172m is denominated in GBP. There were also several small facilities outstanding aggregating to $104.8m. The rise in debt levels since 2014 relates primarily to the substantial capital expenditure that has been required to bring Kraken into production.

$ million	30-Jun-18	30-Jun-14
Multi-currency Revolving Credit Facility(ii) ('RCF')	1,084.3	
Bonds	973	
Other small facilities aggregated	104.8	
Cash and cash equivalents	-188.7	
Net debt	1,973.4	716.7

Following a series of pre-payments in second half of the year, the net debt position has fallen approximately $200m to $1.77bn at 31st October. This figure is flattered by the £107m rights issue to fund the Magnus transaction discussed below, which was mid completion at 31st October. The number likely also benefited from FX translation of the GBP 7% notes. In any case, cash generation coupled with the monthly amortisation of some of the other small facilities mentioned in table above means that the debt position is edging lower, albeit slowly.

Debt cover / Covenants

In the first half of 2018 EnQuest generated EBITDA of $311.9m (H 2014: $284m) versus finance/lease charges of $114.7m, coverage of 2.7x.

A recent RBC piece suggested the group could breach its banking covenants this year if the oil price remained sub $60 per barrel. They have since corrected that note as they had wrongly identified the key bank debt/ebitda covenant as 1.1x which the company has now confirmed to be 1.5x. With the term facility down to $785m and estimated cash position of $300m we don't see any near-term risk of a breach of the senior debt/ebitda covenant.

Debt commitments

Following the prepayments in 2018, the amortisation schedule for 2019 is now less onerous. There is $105m due for repayment in April and a further $100m in October.

We estimate the cash position to be circa $300m currently, which excludes an undrawn $75m RCF. If we assume circa $50-100m is required for working capital, the liquidity position appears to be satisfactory.

EnQuest's assets

EnQuest's assets are predominantly located in the North Sea and to a lesser extent in Malaysia; for the first 10 months of 2018 through to 31st October, UK assets produced a net daily average of 54,268 Boepd.

Region	1st Jan 2018 to 31st Oct 2018 Boepd	1st Jan 2017 to 31st Oct 2017 Boepd	June 2014 Boepd
Northern North Sea (*Thistle/Deveron, Heather/Broom, Dons/Ythan, Magnus*)	17,742	15,251	23,111
Central North Sea *(Alma/Galia, Greater Kittiwake Area, Scolty/Crathes, Alba)*	6,160	8,725	2,181
Kraken	22,156	2,709	
Total UK Assets	46,058	26,685	
Total Malaysia	8,210	8,725	
Total EnQuest	54,268	35,410	25,292

- **North North Sea** saw a 16.3% increase in production to 17,742, driven by Magnus, as well as better performance at Heather/Broom.
- **Central North Sea** production declined from 8,725 to 6,160 driven by lower performance at Scolty/Crathes and Alma/Galia although overall, the result was slightly better than expected by the group.
- **Kraken** produced 31,247 Boepd; although after a planned March shut-down for maintenance, the field averaged 33,000 in July/August, with production for 2019 expected in the 30,000 to 35,000 range. Since first production, the field has produced 10m barrels of oil, with 20 cargoes offloaded from the FPSO.
- **Malaysia's** daily average totalled 8,210, down from 8,969 a year previously, reflecting natural declines.

Comment

At the end of 2017 the group stated it had 210 million barrels of 2P reserves (proved and probable). Following the acquisition of the 75% of Magnus that the group did not already own, 2P reserves increase to 270 million barrels, which the group estimates to be worth an additional $500m after costs, based on a $70 per barrel long time oil price.

There is also a potential equity farm-out of Kraken which could materialise, although mid-year the group opted to raise $175m from Och Ziff secured on 15% of the field's equity and cash flows, to be paid back within 5 years. Following a conversation with investor relations, it is clear the company remains open to any transactions for Magnus and Kraken which could help to reduce indebtedness.

Below we have estimated EnQuest's free cash generation in 2019 based on an oil price range of $40-70 per barrel. We have based the figures on the group's most recent guidance for production and capex.

Our calculation suggests that the group needs a price of circa $41 per barrel to break even; at $60 per barrel we think the group can generate circa $440m of surplus free cash flow. The actual result will be impacted by the extent of any hedging that the group puts in place during the year. At last update in December the group commented there is a *"collar in place for c.1.5 MMbbls of oil for the last two months of 2018 with a floor of c.$69/bbl and a cap at c$80/bbl; three-way collar options for c.3.0 MMbbls of oil in place for the first quarter of 2019 at an average floor price of c.$70/bbl and the call spread between c.$78/bbl and c.$84/bbl"*.

	2018 est.	2019 est.			
Price per barrel ($)	50	40	50	60	70
Daily output (Boepd)	54,000	63,000	63,000	63,000	63,000
Barrels Annual (m)	20	23	23	23	23
Revenue ($m)	986	920	1,150	1,380	1,610
Opex ($m)	473	552	552	552	552
Op Profit ($m)	512	368	598	828	1,058
Interest Expense ($m)	138	138	138	138	138
Op Profit - Interest ($m)	374	230	460	690	920
Free cash after opex, finance charges, capex ($m)	**124**	**-20**	**210**	**440**	**670**

Upcoming debt repayments this year include $105m due in April and $100m in October; with overall production this year expected to be 20% higher at 63,000-70,000 Boepd, our estimates suggest an oil price of $55 per barrel would allow the group to meet those repayments from this year's cash flows. Although as previously mentioned, we think the liquidity position of $387m at end of October means group should meet be able to comfortably meet its commitments this year in a break-even scenario.

EnQuest's two bonds are toggle notes meaning that if the average oil price is below $65/per barrel for the six calendar months prior to the coupon, then the notes can pay in kind (i.e. through bond issuance). Over the last 6 months the price has averaged $74 per barrel so we would expect the next coupon due February to be paid in cash on the GBP notes unless there is significant weakness in the spot price between now and coupon date. The probability of the USD notes "toggling" is harder to judge currently, with the next coupon not until in April.

Conclusion

Our assessment of free cash flow generation above suggests the group is capable of material debt reduction this year at oil prices above $60 per barrel. These projections should be treated with caution as there are many variables. We have assumed 2019 operating costs per barrel at $24 but have seen commentary from other analysts to suggest that figure could be circa $27. That assessment may prove too high according to the company, but later life assets such as Magnus typically have opex costs in the low $30s/bbl with increased production from Kraken materially offsetting this figure (unit opex at Kraken is around $6/bbl).

We opted to use 63,000 boepd for 2019 which was at the low end of the range suggested by the company in December. But we haven't made any allowance for shutdowns which could lead to guidance undershoot. EnQuest does have disappointing track record here unfortunately, as Kraken was expected to be churning out 50,000 boepd by now (guidance for 2019 is currently 30-35,000).

Near term factors for the bonds include the trading update in late January, ongoing fluctuations in the price of oil, and any subsequent equity deals in relation to the estate, which could potentially accelerate debt reduction.

We have found the company helpful and prompt to reply in relation to our enquiries.

Please call the desk if you have any questions.

Rupert Harcus / Richard Isbister