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EnQuest plc

Ticker: ENQLN

Isin	Issue Size	Rating M / S&P	Coupon	Min Piece	Maturity	Next Call	Clean Price	Dirty Offer	YTM (worst)
XS0880578728	£190.5m	- / Caa1	7.00% s/a	£1.00	Oct 2023	n/a	98.37	101.5	8.04%
XS1517932585	$827.2m	- / B-	7.00% s/a	$1k	Oct 2023	10d notice @ par	95.03	97.1	10.01%

EnQuest is a North Sea oil production company that has made the best of its 2016 restructuring to reduce leverage. It has planned debt reduction that should bring reported total debt down from c.$1.5bn to $1.2bn during 2022, and possibly lower. That plan also provides a catalyst for very attractive returns via refinancing of the dollar bond this year (well into double digits) or by June 2023 (10%). Cash generation per EnQuest's base case means they should be able to get the refinancing done and continue to delever at a good clip thereafter.

Bond

- The notes are senior unsecured, issued out of the group holding company, and guaranteed by seven subsidiary companies. They are subordinated to the senior secured RBL and guarantees are also senior subordinated.
- Split into the smaller "retail bond" and the larger "high yield bond".
- One month prior to the coupon dates, the six-month average oil price is determined with reference to the Dated Brent Future (Platts) price. If the average is below $65bbl, coupons are PIK and increase the bond amounts outstanding; if it's above $65bbl, coupons are paid in cash.
- **If the high yield bond is refinanced as intended prior to the maturity of new senior secured borrowing base debt facility ("RBL", $600mn, June 2023), the RBL automatically extends to June 2028.** If not, the RBL will be paid out in June 2023.
- Change of control put at 101.
- Events of default: failure to pay principal when due, interest (30d grace), breach of covenants (merger, consolidation, sale of assets; failure to redeem at change of control 30d from written notice; any other agreements in indenture 60d; final judgments $100mn; guarantee unenforceable; insolvency).
- Cross default is in place between the retail notes and high yield notes. There is a $100mn hurdle for cross default arising from failure to pay any other debt at final maturity that results in acceleration.
- There are no financial covenants as such, although a consolidated leverage ratio maximum of 2.0x or a fixed charge coverage ratio of at least 2.25x must be met for certain restricted payments, additional debt, and mergers/consolidation/sale of assets. Financial covenants relating to leverage and liquidity on the new RBL provide some backup for noteholders in this respect (see Funding section).
- Capital leases are limited to the greater of $120mn and 3.5% of total assets, although that limit does not apply to the major kit needed for oil & gas production. There are restrictions on asset sales ($50mn minimum, non-cash consideration can't exceed the greater of $250mn / 5.0% of total assets, the latter being $189.5mn at 1H 2021). Restricted payments have several carve-outs ranging from $1mn to $250mn.
- The Sterling retail bond has a make whole provision (+50bps) that would make them a bit more expensive for early redemption, but not impossible.

Business

Enquest is an oil & gas production and development company operating in the North Sea (92% of revenue) and Malaysia (8%). It was created in 2010 from the combination of UK North Sea assets from Petrofac and Lundin Petroleum. Its focus is maturing and underdeveloped assets, extending asset life and maximising recovery. Oil prices entered a steep bear market in 2014 and the group was restructured via a scheme of arrangement in late 2016. Current market capitalisation is c.£409m.

The business operates across Upstream, Infrastructure, and Decommissioning activities. Adding to those, new energy is seen as a way of extending the life of Enquest's Sullom Voe Terminal and a collaboration with Shetland Islands Council is underway to develop a sustainable energy hub for Shetland.

Although Enquest's operations were not particularly disrupted by Covid-19, oil prices were; the April 2020 low of just under $16bbl was the lowest price since 2001. It recovered to record an average for 2020 of slightly over $43. During 2021 Brent crude rose from $50 to $87 at the highpoint, with an average of $70 providing a welcome cashflow boost to operators. It enabled early prepayment of senior debt and continued reduction in EnQuest's overall leverage. In 1H 2021 Enquest agreed to acquire Suncor's non-operating equity interest (26.69%) in the Golden Eagle area for $325mn. Contingent consideration of up to $50mn is due in H2 2023 depending on the average oil price between July 2021 and June 2023. The transaction completed on 22nd October and will add 10k boepd in 2022, compensating for the higher decline rates typical in EnQuest's portfolio.

Peer Group Comparison

The three oil and gas producers we have looked at recently show the same pattern of losses in YE 2020 followed by a welcome return to profit in 1H 2021. EnQuest is firmly in the middle in terms of size and leverage, although we see it improving fairly rapidly.

USD millions unless otherwise indicated	**EnQuest**		**Okea**		**Tullow**	
Established	2010		2015		1986	
Geography	North Sea, Malaysia		North Sea		Africa, Sth America, Nth Sea	
Operations	Production, Decommissioning		Development, Production		E&P, Decommissioning	
Market Cap $ million	408.3		350.4		854	
	YE Dec 2020	**1H Jun 2021**	**YE Dec 2020**	**1H 2021**	**YE Dec 2020**	**1H Jun 2021**
Average net working interest production boepd	50,334	41,041	16,147	c16,000	74,900	61,230
2P reserves mmboe	189	181.6	41.6	38.7	260	235
Cost of production $ bbl (reported)	15.00	19.00			12.10	12.90
Revenue	865.6	481.3	201.7	131.4	1,396.1	726.8
EBITDA (reported TTM)	551.0	575.6	101.1	110.9	803.9	884.9
Operating Profit	(362.0)	165.9	(142.1)	112.2	(1,017.7)	369.5
NPBT	(566.0)	49.1	(143.5)	107.6	(1,273.4)	213.1
Operating Cash Interest Cover (x)	2.0	3.7	2.9	11.4	3.5	3.0
Cash & Equivalents	222.8	275.0	101.6	156.4	805.4	301.8
Net Debt (ex leasing)	1,274.5	919.9	180.1	122.6	2,365.1	2,561.5
Tangible Net Worth	(226.6)	(129.0)	32.1	60.7	(578.2)	79.3
Leverage	2.3	1.6	1.8	1.1	2.9	2.9

Tullow's EBITDA figure is EBITDAX with various adjustments.

Financials **YE 31 December 2020**

Production was already going to be down around 14% in 2020 due to cessation of production in three fields (Thistle, Heather and Alma Galia), but revenue was almost halved to $866mn as the pandemic floored global demand and pushed prices down. Despite the resulting oil and gas asset impairments of $423mn that represented most of the loss before tax of $566mn, EnQuest still managed to delever thanks to operating cash generation of $522mn, not far from the average it has produced over the past decade, and still a respectable 2.0x interest expenses. The PIK toggle allowed the company to preserve cash for debt amortisation (bank and vendor loan repayments) while oil spent the year at an average of c.$43bbl. Tangible net worth turned negative ($227mn).

Overall, EnQuest's balance sheet improvement since its 2016 restructure is apparent despite the introduction of IFRS 16 around the same time, which brought almost $680mn of leases onto the balance sheet in 2017. Since then, bank and bond debt together have dropped from a high of $2.23bn in 2017 to $1.5bn. Finance leases have fallen from a high of $798mn to $648mn over the same timeframe. Historically leasing has been excluded in EnQuest's leverage calculations for covenant testing and reporting purposes. Excluded or not, EnQuest has continued to delever.

Summary Financial Metrics

USD millions KEY METRICS	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18	31-Dec-19	31-Dec-20
Ave Realised Oil Price $bbl (incl hedges)	109.7	100.6	72.0	63.8	53.9	61.2	65.3	41.3
Revenue	961.2	1,028.5	908.5	798.1	627.5	1,298.4	1,646.5	865.6
Oil & Gas Asset Impairments	0.0	(678.8)	(1,224.5)	147.9	(172.0)	(126.0)	(812.0)	(422.5)
EBITDA (reported)	621.3	581.0	464.8	477.1	303.6	716.0	1,007.0	551.0
Operating Profit	386.5	(536.0)	(1,092.4)	277.8	(109.4)	244.0	(418.2)	(362.0)
NPBT	330.9	(70.6)	(1,341.0)	217.1	(243.8)	94.0	(729.1)	(566.0)
Operating Cash Interest Cover (x)	11.8	5.9	1.1	2.9	2.0	3.4	3.6	2.0
Cash & Equivalents	72.8	176.8	269.0	174.6	173.1	240.6	220.5	222.8
Net Debt (excl leases)	385.4	945.5	1,530.8	1,782.8	1,980.2	1,796.4	1,404.8	1,274.5
Tangible Net Worth	1,246.1	1,104.8	431.4	579.2	519.4	647.8	397.1	(226.6)
Leverage	0.6	1.6	3.3	3.7	6.5	2.5	1.4	2.3

Standard EBITDA in this table is EBIT plus depreciation, depletion and amortisation; reported EBITDA also adds back forex gains/losses, intangible impairments and other write offs. Operating cash interest cover is operating cash flow versus interest expense and therefore includes PIK interest. Leverage is as reported, i.e. excluding leasing.

Note that over $800mn of impairments were charged in 2019, including $150mn for goodwill and $638mn that reflected a reduction in long term oil prices and life-of-field expectations at Heather/Broom and Thistle. These were offset by increases identified at growth assets (Magnus, Kraken and PM8/Seligi).

1H 30 June 2021

Despite some operational difficulties, recovery in Brent translated to a 9.8% increase in revenue to $481mn. Lower production costs and an absence of impairments meant reported EBITDA of $345mn and EBIT reversed from a loss of $244mn in 2020 to a profit of $166mn. Although finance costs ($117mn) and tax ($105mn) led to an overall loss after tax of $56mn, that was substantially better than the $472mn loss of 1H 2020. It was also tempered by stable operating cash flow, which at $285mn was able to cover higher decommissioning expenditure ($38mn) and reduce debt while capex was kept low. Net debt excluding leases was $1.18bn after c.$90mn of repayments and a $53mn increase in cash to $275mn. Cash coupon payments made a welcome return. Decommissioning costs of $807mn were on the balance sheet at the half year, $68mn of which were current. $303mn are due in the next 4.5 years. Surety bonds of $165mn are also in place to cover decommissioning.

Production details

Average daily production on a net working interest basis	For the period to 30 June 2021	For the period to 30 June 2020
	(Boepd)	(Boepd)
UK Upstream		
- Magnus	13,847	18,806
- Kraken	23,690	27,472
- Other Upstream[1]	3,504	7,700
UK Upstream	**41,041**	53,978
UK Decommissioning[2]	337	3,771
Total UK	**41,378**	57,749
Total Malaysia	**4,809**	8,306
Total EnQuest	**46,187**	66,055

[1] Other Upstream: Scolty/Crathes, the Greater Kittiwake Area and Alba
[2] UK Decommissioning: Heather/Broom, Thistle/Deveron, the Dons and Alma/Galia

In the second half of 2021, the average Brent price was up over $10bbl to $76.45bbl. Of the $325mn the group paid for Golden Eagle in October, $125mn came from the RBL, $125mn from cash on hand (including $50mn fresh equity), and the remainder from Golden Eagle's cash generation. This represented lower utilisation of the RBL than planned.

Hedging Policy

EnQuest's production hedging policy as follows:

- Up to 75% for the coming 12 months,
- Up to 50% for the subsequent year (13-24 months), and
- Up to 25% for the year after that (25-36 months).

The company's stress testing of assumptions indicates that prices would have to fall to something below $55bbl before the $75mn liquidity covenant on the RBL would be breached. The hedging position as at November 2021 is shown in the table below and indicates hedging of around 51% for the final two months of 2021, c.38% for 2022 and 10% for 2023. With Brent crude averaging around $75bbl for the past twelve months and the current forecasts averaging in the low $70s out to 2023, there is good scope for earnings upside. The lowest average realised price after hedging for EnQuest in the past decade was $41.3bbl in 2020, since then it has risen to $62.8bbl in 1H 2021. The company has continued to generate cash and delever throughout difficult periods of low oil prices, and the hedging policy has clearly been a key supporting factor, along with the PIK toggle.

Timeframe	Volume bbl	Average Floor	Average Ceiling
Nov & Dec 2021	2 MM	-	$74
2022	7 MM	$61	$76
2023	2 MM	$56	$74

Funding

Amortisation under the November 2016 restructuring agreement was scheduled to reduce bank debt facilities from $1.2bn to $435mn in April 2021. That was essentially achieved and the new bank facilities agreed in June 2021 were drawn to $360mn, paying out the prior facility. Facilities are now as follows:

- Senior Secured Borrowing Base Facility $750mn
  - Reserve Base Lending $600mn; initial interest rate 4.25%.
  - Letters of Credit $150mn.
  - Maturity is initially June 2023. If the high yield bond is refinanced the RBL maturity automatically extends to June 2028 or to the point when remaining economic reserves for all borrowing base assets are projected to fall below 25% of the initial economic reserves forecast (187mmboe), whichever comes earlier.
  - Covenants include leverage (net financial debt v. EBITDA <3.5x) and minimum liquidity of £75mn cash headroom. They are tested quarterly for the next 12 months. There is also a requirement for any unrestricted cash excess over $75mnn be swept to repay oustanding amounts at quarter ends.
  - Even after the Golden Eagle acquisition, drawings on the RBL were only $485mn at the end of October versus the original expectation that it would be fully drawn to $600mn after the transaction.
  - Utilisation limit set at $300m by June 2022, with amortisation leading to full repayment by June 2023 in the event the high yield bond is not refinanced by then. On prevailing oil prices, hedges, and cash generation, full repayment looks achievable if need be, but we believe bond refinancing to be more likely.
- Bonds totalling c.$1,087mn 7.00% October 2023 PIK toggle bonds:
  - $827mn – the high yield bond
  - £191mn – the retail bond
  - The PIK toggle has been an effective tool. The group returned to cash coupon payments in 2H 2021 after oil prices rose. Any new bond will likely jettison the PIK toggle feature.
- The pandemic and its related impairment-induced losses pushed the group's net equity to negative $65mn in 2020. Subsequent recalculation of deferred tax assets has apparently brought equity back up to positive $91mn. CEO-related shareholders maintained their 9.25% share of the company through the $50mn raising to fund Golden Eagle. That's on top of the £33.73mn they invested during the 2016 restructure's equity raising.

Outlook – YE 31 December 2021 and 2022

During the second half of 2021, EnQuest experienced compressor system outages in the Magnus field (third party issue); a short, unplanned shutdown and single train operation in the Kraken field; and delays to the pipeline replacement at PM8/Seligi due to support vessel unavailability. Although production for the ten months to the end of October was down 17% to 44,306 boepd due to those issues and planned cessations of production, higher oil prices made up for the shortfall. Difficulties in the North Sea operations should have been largely rectified by the end of 2021, but there have been some additional covid-related personnel issues as well. PM8/Seligi may get back to normal around the end of Q1 2022.

Management has indicated production will be around 48k boepd for the year, which is made up of 46k boepd (the lower end of existing fields original production expectations) and the extra 2k boepd coming from Golden Eagle's contribution for the final 9-10 weeks of the year. Higher oil prices in the second half will also assist and on a conservative basis we expect reported EBITDA of $700mn for the 12 months at a minimum. Annual operating cash flow of $600mn or better seems a reasonable estimate with upside potential.

EnQuest has said that net debt will be around the same as YE 2020, i.e. c.$1.3bn, with the RBL is drawn to $435mn or so by year end thanks to an early voluntary repayment of $50mn. We estimate leverage will be down to 1.9x or so. Looking forward to 2022, we are confident the RBL will hit its $300mn utilisation target on schedule by the end of June 2022. With higher prices, we see EnQuest as capable of generating $770mn in operating cash flow, with $400mn available to apply to further debt and leverage reduction.

Management is weighing up the alternatives with regard to the bond refinancing; the longer they wait, the better accumulation of cash to lower the amount, whether to refinance the retail bond at the same time or wait for it to mature, market conditions with regard to amount and potential to lower the interest rate from the current 7%. In October this year the bond maturity becomes a going concern issue, which does tend to focus the minds of senior management. According to EnQuest, they will make sure they are ready to press go on a refinancing. The most likely windows would be around the YE 2021 results (end of March) or the half yearly results (September).

View

EnQuest has a track record of overall debt reduction and solid cash generation over the five years since its restructure. It has managed through the pandemic-induced downturn well and added the Golden Eagle acquisition to maintain production volumes. The new RBL has built in requirements to maintain the delevering trajectory that can be accelerated with the high oil prices currently on offer. The expected refinancing of the high yield bond in the next 6-18 months offers a good opportunity for a high return.

A production update should be issued around the start of February, probably with guidance for 2022 production, etc, followed by full year results at the end of March. Please contact the desk if you wish to discuss.

Penelope Fitzherbert

26 January 2022

Brent Crude Oil Price 2010 – 2021

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