EDISON

# Hurricane Energy

FY19 results

## Positive results ahead of unprecedented times

Oil & gas

**Hurricane Energy recently reported its first year of production and revenues from the sale of oil produced from the Lancaster early production system (EPS). The company reported FY19 revenue of c $170m, in line with our previous estimates. In this note we update our valuation to reflect FY19 results and the current oil and gas industry macroeconomic situation. The coronavirus (COVID-19) and the Russia/Saudi Arabia price war have affected oil and gas global supply and demand and consequently oil prices. Our mid-case risked valuation has decreased to 73.0p/share from 109.9p/share (-34%) as we adjust our short- and long-term oil price assumptions and update our forecasts to reflect Lancaster's accelerated programme, and removal of the Great Warwick Area (GWA) tie-back.**

| Year-end | Revenue ($m) | EBITDA ($m) | Operating cash flow ($m) | Capex* ($m) | Net debt/ (cash) ($m) |
|---|---|---|---|---|---|
| 12/18 | 0.0 | (12.6) | (4.4) | (209.9) | 99.5 |
| 12/19 | 170.3 | (11.7) | 112.2 | (55.4) | 38.2 |
| 12/20e | 240.8 | 112.3 | 127.3 | (71.4) | (20.8) |
| 12/21e | 315.6 | 187.1 | 172.9 | (332.7) | 139.0 |

Note: *Capex is net of carried investment by Spirit Energy.

## FY19 was a transformational year for Hurricane

The company achieved first oil from the Lancaster field in May 2019, and has produced at an annualised average rate of 12.9kbopd. The well also produced data required to help clarify some characteristics of the reservoir, while generating cash to fund the next steps of activity. Hurricane's FY19 results were broadly in line with our expectations, with revenues of c $170m.

## Current market headwinds

2020 is proving to be a challenging year for the oil and gas industry. In January, geopolitical events around Iran resulted in market instability, later followed by the coronavirus outbreak and the Russia/Saudi Arabia oil price war. These disruptions to the supply/demand balance are already having an impact on results in Q120, with the EIA estimating oil demand in Q120 to be 0.9mmbod lower than in Q119. Hurricane management is revising its near-term capital allocations and working programme, aiming to prioritise existing cash and the allocation of cash flow from operations towards strengthening the balance sheet so it can absorb downside risks and meet future financial liabilities.

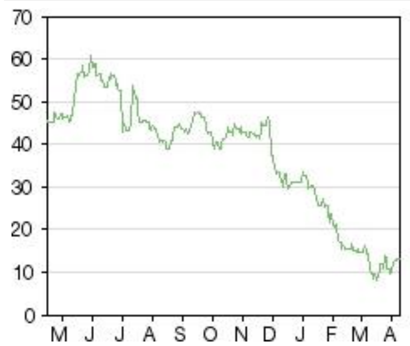
## Valuation: Core NAV at 23.7p/share

Our risked valuation stands at 73.0p/share, or 23.7p/share excluding any value beyond Lancaster EPS. Changes to our valuation include removal of the GWA tie-back and inclusion of a GLA tie-back instead, with management estimating first oil in Q122, dependent on an oil price recovery. We have updated our short-term Brent price expectations based on EIA forecasts. Our long-term (2022 onwards) Brent assumptions have also been revised. Our sensitivity analysis of changes in the long-term oil price include three scenarios with the 2020 Brent price inflated at 2.5%, starting at $40/bbl (low case), $50/bbl (mid-case) and $60/bbl (high case).

**14 April 2020**

| | |
|---|---|
| **Price** | **12p** |
| **Market cap** | **£243m** |
| | US$1.28/£ |
| Net debt ($m) at 31 December 2019 | 38.2 |
| Shares in issue | 1,992m |
| Free float | 81% |
| Code | HUR |
| Primary exchange | AIM |
| Secondary exchange | N/A |

### Share price performance




| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | (9.0) | (56.1) | (71.8) |
| Rel (local) | 4.4 | (41.2) | (63.5) |
| 52-week high/low | | 60.8p | 8.21p |

### Business description

Hurricane Energy is an E&P focused on fractured basement exploration and development in the West of Shetland region. The company's 100%-owned Lancaster oil discovery (523mmbbl 2P reserves + 2C resources) achieved first oil on target in H119.

### Next events

| | |
|---|---|
| Capital markets day | To be decided |

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## FY19 marks first year of production for Hurricane

In 2019, Hurricane delivered first production from the Lancaster field, a significant landmark for fractured basement reservoirs in north-west Europe, and for the company. Not only is the Lancaster EPS a play-opening development, but Hurricane also completed the project on time and on budget. In production since May 2019, the Lancaster EPS produced at an average rate of 12.9kbopd and generated data required to help clarify some characteristics of this unique fractured basement reservoir, while also generating cash to fund the next steps of activity without further calls on shareholders. Hurricane's FY19 results were broadly in line with our expectations. Revenues of c $170m were recorded and operating costs were in line with pre-start-up expectations. The overall result was an operating cash flow of c $112m at the year end. However, following recent macroeconomic headwinds such as the impact of COVID-19 on global energy needs and the Russia/Saudi Arabia price war, we have reviewed our forecasts for FY20.

### FY20 work plan under revision

Since year-end, production has been gradually increased to the target of 20kbopd. While well production performance has been above expectations, there have been some unanticipated aspects including the presence of a previously unidentified water zone within the productive interval of the 205/21a-7z well. The Lancaster EPS was designed with the objective of obtaining more reservoir data over an extended period of time, to allow the company to draw key conclusions to define the potential scale of full field development. More information on the technical results of the EPS will be announced at the company's capital markets day, which was previously scheduled for 25 March 2020 but postponed due to the coronavirus outbreak.

In the GWA, following the 2019 drilling campaign, the JV materially increased its understanding of this part of the Rona Ridge, which appears to have less well-developed reservoir qualities compared to Lancaster. As a result, the JV is reassessing the next stage of activity in the GWA, and has adjusted the JV cost allocation arrangements accordingly. The JV had previously agreed on a phased work programme including the tie-back of a GWA well to the Aoka Mizu FPSO, as well as modifications to the vessel and gas export tie-in to the West of Shetland Pipeline System (WOSPS). Phase 2 of the work programme (where Hurricane is 50% carried up to a gross cost of $187.5m) starts post the final investment decision on a GWA tie-back. However, the JV is still evaluating the future working programme. All costs incurred in preparation for Phase 2 have therefore been funded on a 50:50 basis.

The GWA JV has now agreed a new cost allocation where the JV will build out the equipment and materials required to tie back a single well from the GWA to the Aoka Mizu FPSO on a 50:50 basis. Hurricane can elect to continue to build out long-lead items related to the tie-in of the Aoka Mizu FPSO to WOSPS on a sole basis at a cost of c $28.0m, giving Hurricane greater optionality relating to gas export. Hurricane has no current plans to proceed with the WOSPS installation, but in the event that a decision is taken to proceed in the future, Hurricane would bear 100% of the associated costs, currently estimated to be in the region of $62.0m, and would reimburse Spirit for related gas export past costs up to 31 January 2020 (excluding carry) of approximately $18.0m, only where installation occurs prior to GWA JV approval of Phase 2. If at any time Phase 2 is approved and a GWA tie-back proceeds, Hurricane will benefit from the original terms through retrospective application of the carry in the proportions originally agreed.

As presented in our previous note, the licence extensions granted to Hurricane encompass a commitment well in each of the Lancaster and Lincoln sub-areas. In the GWA, we understand that Hurricane is planning one or more sub-vertical wells with the objective of determining the maximum vertical extent of the Lincoln field and, at a minimum, confirming the mid-case oil-water contact at

2,200m. Consequently, the company no longer plans to drill any additional horizontal producers on the GWA in 2020 and an option being considered is drilling a third horizontal producing well in Lancaster. First oil from this well, if drilled, would be expected in Q122.  A decision to proceed with drilling is dependent on oil price environment. In the Greater Lancaster Area (GLA), the work programme will include one or more sub-vertical wells to determine the maximum extent of the Lancaster field in 2021.

Hurricane has further drilling opportunities in the area, both to expand near-term production and reduce uncertainty over the scale of long-term resources that might be exploited in a full field development. However, the operating environment West of Shetland is capital intensive. Considerable caution over the scale and pace of future capital spending commitments is therefore appropriate at the present time. We understand the company has also been working with the Oil and Gas Authority, the regulator for the UK oil and gas industry, which plans to take a flexible approach. This will be important for Hurricane's cost allocation considering its well commitments in the short term. Hurricane will therefore prioritise existing cash and the allocation of cash flow from operations towards creating a strong balance sheet with an ample cash cushion to absorb downside risks and meet future financial liabilities. Capital spending will be focused on licence obligations and drilling options to maximise shareholder value uplift at minimum cost.

## Coronavirus and price war impact in the market

Since the beginning of the year, the share prices of Hurricane and its peers have considerably decreased. Concerns about lower global demand for oil and gas have had an impact on commodity pricing. Lower demand is already being observed, especially in China, with oil liquids consumption decreasing from 15.2mmbod in December 2019 to 13.1mmbod in February 2020, as reported by the EIA. In addition to the coronavirus outbreak, an oil price war between Saudi Arabia and Russia broke out on 9 March 2020. The OPEC+ ramp-up in production came just as demand significantly reduced as a result of the coronavirus. According to press reports, Saudi Arabia was signalling that it would cut production to maintain oil prices. However, when Russia decided it was unwilling to accept its proposed share cut of 0.2–0.3mmbod, Saudi Arabia cut its selling prices, triggering the oil price crash. With falling demand and increased hydrocarbons supply, realised prices have decreased, affecting producing companies' results. According to management, although the Lancaster EPS has cash operating costs of c $17/bbl at current production levels and oil prices, operating cash flow from the Lancaster EPS will be materially lower than previously forecast. The key question now is how long the lower global oil demand will persist and how quickly the global economy will recover.

### Dealing with the threat

Hurricane has been reviewing government restrictions and industry measures to combat the spread of the coronavirus. Recently, a crew member of the Aoka Mizu FPSO was evacuated to the mainland for medical reasons and subsequently tested positive for COVID-19. The individual was transported onshore to receive medical treatment and production operations at Lancaster were not affected.

# Valuation

We value Hurricane's asset base using a conventional risked net asset value (NAV) approach, based on a risked valuation for proven reserves, and contingent and prospective resources. Key assumptions include estimates of production profiles, asset development costs and operational costs, in addition to realised commodity prices. We have updated our forecasts and NAV to reflect Hurricane's 2019 full year results, together with the impacts of the coronavirus and Russia/Saudi

Arabia oil price war. Our risked valuation has decreased to 73.0p/share, or 23.7p/share excluding any value beyond Lancaster EPS. The main changes in our modelling assumptions include:

- Since the GWA JV concluded that it will not be possible to tie back the Lincoln Crestal Well to the Aoka Mizu FPSO in 2020, we have removed the GWA tie-back from our valuation. Previously assumed GWA tie-back reserves have been reallocated to the GWA full field development.
- Contingent on successful drilling of Lancaster-8 and subject to regulatory consents, Hurricane is planning to tie-back the well to the Aoka Mizu FPSO in 2021. Management estimates a provisional first oil date in Q122; however, any activity is contingent on the oil price environment. We risk the development with a 90% geological chance of success and 50% commercial chance of success. The company is not making any commitment to capital expenditure in respect of the installation of the tie-back until the well has been successfully tested.
- Our short-term Brent assumptions change from \$64.8/bbl to \$43.3/bbl in FY20, and from \$67.5/bbl to \$55.4/bbl in FY21, based on EIA forecasts as published in March 2020. We have also revised down our long-term oil price expectation of \$70/bbl Brent from 2022 to reflect current oil price volatility. We present three scenarios with Brent in 2020 at \$40/bbl in our low case scenario, \$50/bbl in our mid-case scenario and \$60/bbl in our high case scenario, inflated at 2.5% per year, resulting in 2022 prices of \$42.0/bbl, \$52.5/bbl and \$63.0/bbl respectively. Given the current oil price volatility, we will continue to monitor market conditions closely and may revisit these assumptions in due course.

**Exhibit 1: Changes to the short-term oil and top-line forecasts**

| | Actual | New | | Old | | | Difference | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 |
| Production (kbopd) | 7.6 | 17.0 | 17.0 | 7.6 | 17.0 | 21.3 | 0% | 0% | -20% |
| Brent (\$/bbl) | 64.36 | 43.30 | 55.36 | 64.36 | 64.83 | 67.53 | 0% | -33% | -18% |
| Revenue (\$m) | 170.3 | 240.8 | 315.6 | 166.5 | 374.3 | 488.9 | 2% | -36% | -35% |

Source: Edison Investment Research

We have not updated our resource base estimate since this is still under evaluation. We expect to have further details on the near-term work programme and any possible implications of the current weak oil market conditions at Hurricane's capital markets day, which was expected to be on 25 March 2020 but has been postponed due to impossibility to conduct the event on coronavirus restrictions. A further update will be provided to the market once a new date and format for the event has been confirmed. The NAV table below provides a breakdown of our current valuation by asset.

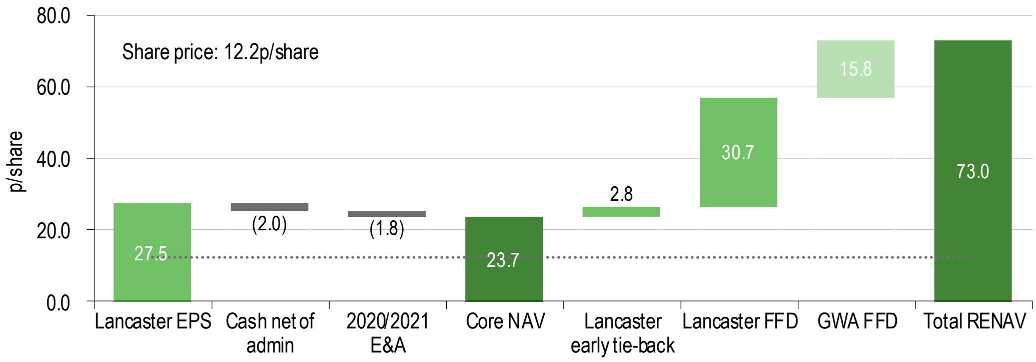
**Exhibit 2: Edison breakdown of Hurricane NAV**

| | | | | Recoverable reserves | | | | Low case (\$40/bbl) | Mid case (\$50/bbl) | High case (\$60/bbl) |
|---|---|---|---|---|---|---|---|---|---|---|
| Asset | Country | Diluted WI | CCoS | Gross | Net | NPV/boe | Net risked value | Net risked value per share | | |
| | | % | % | mmboe | mmboe | \$/boe* | \$m | p/share | p/share | p/share |
| Net debt at 31 December 2019 | | | | | | | (38) | (1.2) | (1.2) | (1.2) |
| SG&A (3 years) | | | | | | | (24) | (0.8) | (0.8) | (0.8) |
| 2020/2021 E&A wells | | | | | | | (55) | (1.8) | (1.8) | (1.8) |
| Lancaster EPS - 10y | UK | 100% | 100% | 56 | 56 | 15.4 | 858 | 22.3 | 27.5 | 32.3 |
| **Core NAV** | | | | **56** | **56** | | **741** | **18.6** | **23.7** | **28.5** |
| Lancaster early tie-back | UK | 100% | 45% | 22 | 22 | 9.1 | 89 | 1.8 | 2.8 | 3.9 |
| Lancaster FFD** | UK | 46% | 81% | 425 | 195 | 6.1 | 959 | 22.7 | 30.7 | 38.6 |
| GWA FFD (part carried) | UK | 50% | 42% | 499 | 250 | 4.7 | 493 | 9.4 | 15.8 | 21.9 |
| **Total inc exploration RENAV** | | | | **555** | **306** | | **2,282** | **52.6** | **73.0** | **93.0** |

Source: Edison Investment Research. Note: *Number of shares = 2,434.2, assumes conversion of convertible debt. **Assumes farm-down and carry, 20% IRR.

As can be seen in Exhibit 2, our valuation of Hurricane is highly sensitive to oil price assumptions, unlike some industry players with exposure to gas and fixed price contracts. In our mid case, we use the EIA's short-term forecasts ($43.3/bbl Brent in 2020 and $55.4/bbl in 2021) and a long-term oil price of $50/bbl (from 2022) inflated at 2.5% onwards. At our current pricing assumptions, our risked NAV valuation for Hurricane, excluding any value beyond Lancaster EPS, stands at 23.7p/share, 95% higher than the current share price. Our Core NAV valuation in a low case is 52% higher than the current share price at 18.6p/share. We note that in the short term any positive data from the capital markets day should be supportive of the share price.

**Exhibit 3: Hurricane RENAV waterfall**



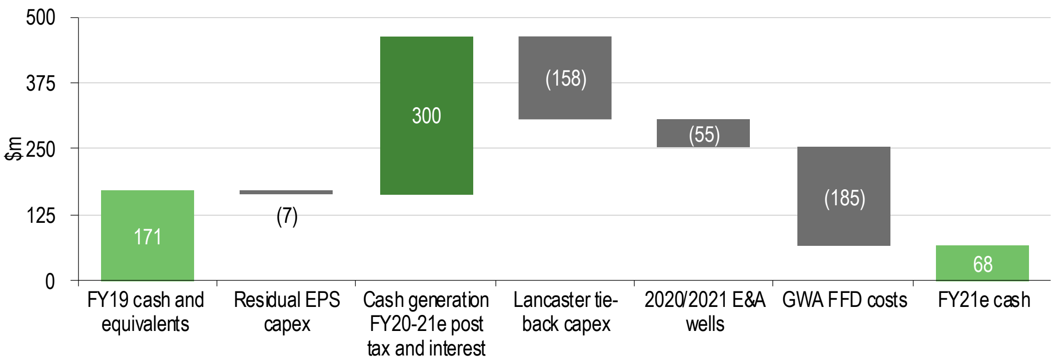

Source: Edison Investment Research

## Financials

Short-term financial forecasts will be driven by performance of the Lancaster EPS and Brent price. Consequently, there is significant uncertainty in precise forecasts of revenue and cash flows. However, we expect Lancaster EPS cash flows to provide enough cash for appraisal and development of the rest of the short-term portfolio.

Hurricane remains relatively unlevered, with the company's only debt being a $230m convertible bond due in 2022 bearing interest of 7.5% and convertible at $0.52/share. We assume the bond converts in our RENAV, treating this debt instrument as equity. Below we look at a cash flow bridge, which highlights Hurricane's potential to fund capital commitments through to end 2021 from a combination of existing cash resources, cash flow from EPS operations and existing cost-carry arrangements.

**Exhibit 4: End FY19 to end FY21e cash flow bridge***




Source: Edison Investment Research. Note: *Outstanding convertible bond of $230m due in 2022 if not redeemed prior to maturity.

## Exhibit 5: Financial summary

| $m | 2017 | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|---|
| Year-end 31 December | IFRS | IFRS | IFRS | IFRS | IFRS |
| **PROFIT & LOSS** | | | | | |
| Revenue | 0.0 | 0.0 | 170.3 | 240.8 | 315.6 |
| Operating Expenses | (14.6) | (12.7) | (118.9) | (200.1) | (200.1) |
| EBITDA | (14.6) | (12.6) | (11.7) | 112.3 | 187.1 |
| Operating Profit (before amort. and except.) | (14.6) | (12.7) | 51.4 | 30.7 | 105.5 |
| Exploration expenses | (10.4) | 0.0 | (66.5) | 0.0 | 0.0 |
| Exceptionals | 10.4 | (42.4) | 34.7 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Operating Profit | (14.6) | (55.0) | 19.7 | 30.7 | 105.5 |
| Net Interest | 7.6 | (5.9) | (21.5) | (14.2) | (14.2) |
| Profit Before Tax (norm) | (7.0) | (18.5) | 30.0 | 16.5 | 91.3 |
| Profit Before Tax (FRS 3) | (7.0) | (60.9) | (1.8) | 16.5 | 91.3 |
| Tax | 0.0 | 0.0 | 60.5 | 0.0 | 0.0 |
| Profit After Tax (norm) | (7.0) | (18.5) | 90.5 | 16.5 | 91.3 |
| Profit After Tax (FRS 3) | (7.0) | (60.9) | 58.7 | 16.5 | 91.3 |
| Average Number of Shares Outstanding (m) | 1,583.8 | 1,959.6 | 1,978.5 | 1,991.9 | 1,991.9 |
| EPS - normalised (c) | (0.4) | (2.2) | (2.5) | 12.9 | 13.9 |
| EPS - normalised and fully diluted (c) | (0.4) | (2.2) | 0.3 | (2.2) | (11.9) |
| EPS - (IFRS) (c) | (0.4) | (3.1) | 3.0 | 0.8 | 4.6 |
| Dividend per share (p) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Gross Margin (%) | N/A | N/A | 30.2 | 16.9 | 36.6 |
| EBITDA Margin (%) | N/A | N/A | -6.9 | 46.6 | 59.3 |
| Operating Margin (before GW and except.) (%) | N/A | N/A | 30.2 | 12.7 | 33.4 |
| **BALANCE SHEET** | | | | | |
| Fixed Assets | 587.9 | 884.2 | 932.5 | 867.9 | 1,119.0 |
| Intangible Assets | 126.4 | 131.5 | 75.9 | 78.8 | 78.8 |
| Tangible Assets | 445.3 | 728.2 | 796.2 | 783.0 | 1,034.1 |
| Investments | 16.3 | 24.5 | 60.5 | 6.1 | 6.1 |
| Current Assets | 350.1 | 106.0 | 228.7 | 287.8 | 128.0 |
| Stocks | 1.4 | 4.6 | 9.9 | 9.9 | 9.9 |
| Debtors | 4.7 | 2.6 | 50.4 | 50.4 | 50.4 |
| Cash | 343.9 | 98.9 | 168.4 | 227.4 | 67.6 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Current Liabilities | (28.8) | (55.1) | (94.4) | (72.4) | (72.4) |
| Creditors | (28.8) | (55.1) | (94.4) | (72.4) | (72.4) |
| Short term borrowings | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Long Term Liabilities | (226.7) | (307.0) | (375.8) | (375.8) | (375.8) |
| Long term borrowings | (191.1) | (198.4) | (206.6) | (206.6) | (206.6) |
| Other long term liabilities | (35.6) | (108.7) | (169.2) | (169.2) | (169.2) |
| Net Assets | 682.5 | 628.1 | 691.1 | 707.5 | 798.9 |
| **CASH FLOW** | | | | | |
| Operating Cash Flow | (8.1) | (4.4) | 112.2 | 127.3 | 172.9 |
| Cash tax paid | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Capex | (265.7) | (209.9) | (55.4) | (71.4) | (332.7) |
| Acquisitions/disposals | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Financing | 322.3 | 163.4 | 13.1 | 0.0 | 0.0 |
| Dividends | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net Cash Flow | 48.5 | (50.9) | 69.8 | 56.0 | (159.8) |
| Opening net debt/(cash) | (98.6) | (152.8) | 99.5 | 38.2 | (20.8) |
| HP finance leases initiated | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 5.7 | (201.4) | (8.6) | 3.1 | 0.0 |
| Closing net debt/(cash) | (152.8) | 99.5 | 38.2 | (20.8) | 139.0 |

Source: Hurricane Energy, Edison Investment Research

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