

Hurricane Energy

GWA farm-in accelerates resource monetisation

Farm-in update

Oil & gas

5 October 2018

Price **55p**

Market cap **£1,078m**

US\$/£1.33

Net debt (\$m) at June 2018 including convertible debt 30.8

Shares in issue 1,959.6m

Free float 75%

Code HUR

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 0.9 21.1 82.7

Rel (local) 1.7 23.8 83.6

52-week high/low 60p 24p

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 (523mmboe 2P reserves + 2C resources) is targeting first oil in 1H19.

Next events

Lancaster EPS first oil H119

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Hurricane Energy recently farmed out 50% of its Lincoln and Warwick licences covering the Greater Warwick Area (GWA) to Spirit Energy. This transaction is intended to accelerate the de-risking and monetisation of GWA, adding a new leg to the Hurricane business model running in parallel with the development of the Greater Lancaster Area (GLA). Under the terms of the farm-in, Hurricane will retain a 50% working interest in GWA licences in return for a net carry of \$137.2m through a two-phase initial work programme and \$150–250m contingent carry on net GWA full field development (FFD) expense. We update our valuation to reflect the terms of the Spirit Energy farm-in, driving our RENAV from 81.0p/share to 102.8p/share (+26.9%). We believe the transaction materially accelerates the de-risking of Hurricane's Rona Ridge asset base, both in terms of GWA resource and the ability to focus Lancaster EPS cash flows on fast-track appraisal of the GLA resource base. Key valuation uncertainties include resource recovery from the GLA and GWA FFDs – we expect reserve and resource estimates to tighten on the back of further appraisal and EPS performance.

Year end	Revenue (\$m)	EBITDA (\$m)	Operating cash flow (\$m)	Capex* (\$m)	Net cash/ (debt) (\$m)
12/16	0.0	(8.8)	(5.6)	(63.5)	98.1
12/17	0.0	(14.6)	(8.1)	(265.7)	133.5
12/18e	0.0	(4.7)	(10.1)	(229.6)	(114.9)
12/19e	128.4	43.2	28.6	(96.5)*	(182.8)

Note: *Capex is net of carried investment by Spirit Energy and includes 5% cost contingency for EPS.

Lancaster EPS on-track for H119

The Lancaster EPS remains on track for first oil in H119. Subsea umbilicals, risers and flowlines (SURF) installation scope has been completed and next steps involve completion of FPSO sea trials, vessel movement to location, hook-up and commissioning. We continue to assume first oil towards the end of H119, which could prove to be conservative based on current progress.

Active 2019 drilling programme

Hurricane has an active 2019 well programme, with three E&A wells planned for the GWA. The first well is likely to be drilled at Lincoln, which would provide a potential tie-back for the Aoka Mizu FPSO, taking gross oil production to 30kboe. Two further wells target Warwick, testing basement reservoir connectivity across large-scale faults and deep oil productivity closer to mapped oil water contact.

Valuation: GWA farm-in accretive to RENAV

Our valuation increases to 102.8p/share after incorporating the Spirit Energy farm-in, driven by accelerated cash flow from the GWA tie-back to the Lancaster EPS and 500mmboe GWA FFD. We had previously only assumed farm-out of a 250mmboe development for Lincoln. We also increase our short-term oil price assumptions for 2018 and 2019 based on the latest EIA projections.

GWA farm-in details

Partner brings technical expertise and financial firepower

We view Spirit Energy as an appropriate partner for Hurricane Energy, as it brings technical expertise in field development, operatorship capability and financial firepower. Spirit Energy was created in 2017 following the combination of Centrica's exploration and production business (69% owned) and Bayerngas Norge (31% owned), and has a team of more than 800 people focused on assets in Europe, overseeing production of 50mmboe per year, with a reserves/resource base of over 600mmboe.

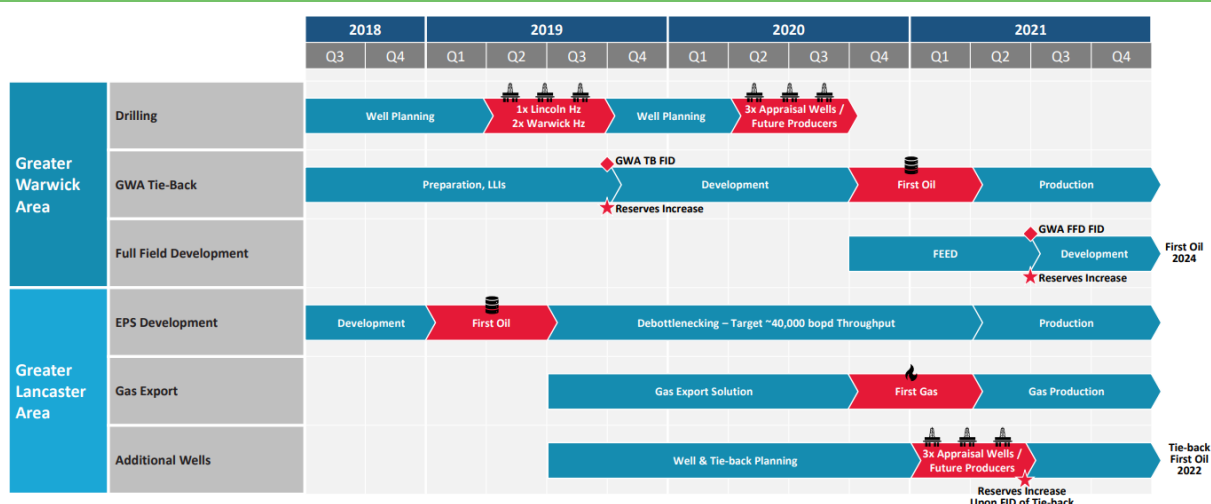
Farm-in five phases

Spirit Energy's farm-in to GWA can be broken down into five distinct phases. In the first, starting in 2019, Hurricane is to be fully carried up to a maximum of \$180.6m gross, on its share of work programme including a three-well drilling programme. This will accelerate the exploration of Warwick and appraisal of Lincoln, including preparation works for the tie-in of one or more producers to the Aoka Mizu. The Transocean Leader semi-submersible has already been contracted, providing visibility on 2019 drilling catalysts.

Contingent on Phase 1 success, in 2020 Hurricane will be 50% carried for its share of an estimated \$187.5m gross programme to tie back one GWA well to the Aoka Mizu, including tie-in to the West of Shetland Pipeline (WOSP) gas export system. The tie-in is a key requirement for enhancing Aoka Mizu throughput to 40kbod, as current flaring consents are unlikely to be extended to cover this level of production.

Phase 3 includes drilling three additional wells on GWA for further appraisal and providing well stock for the FFD. Phase 4 is front end engineering and design (FEED) and Phase 5 sanction of FFD targeting a 500mmboe resource. There will be a further contingent carry contribution by Spirit Energy of \$150–250m for Hurricane's share of GWA FFD costs dependent on the reserves included in the FID for the FFD. Hurricane is to remain operator until commencement of the FFD workstreams (including FEED), at which point operatorship will transfer to Spirit Energy.

Exhibit 1: Hurricane Energy operational activity timeline



Source: Hurricane Energy

The GWA encompasses Lincoln, discovered by Hurricane's 2016 well, 205/26b-12, together with Warwick, which has yet to be drilled. 205/26b-12 established that Lincoln was a separate accumulation to Lancaster, based on the large differences (>500m) seen in the interpreted oil water contact depths of the two structures. Hurricane attributes the barrier effect between Lancaster and Lincoln to the Brynhild Fault Zone, and has also identified a splay system of large-scale faults that may further intersect the GWA.

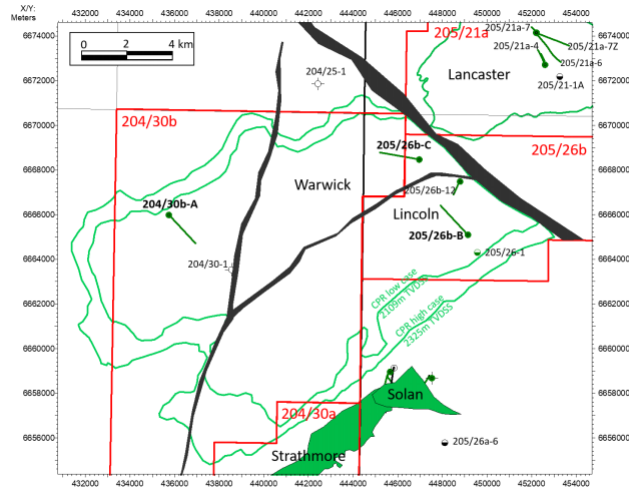
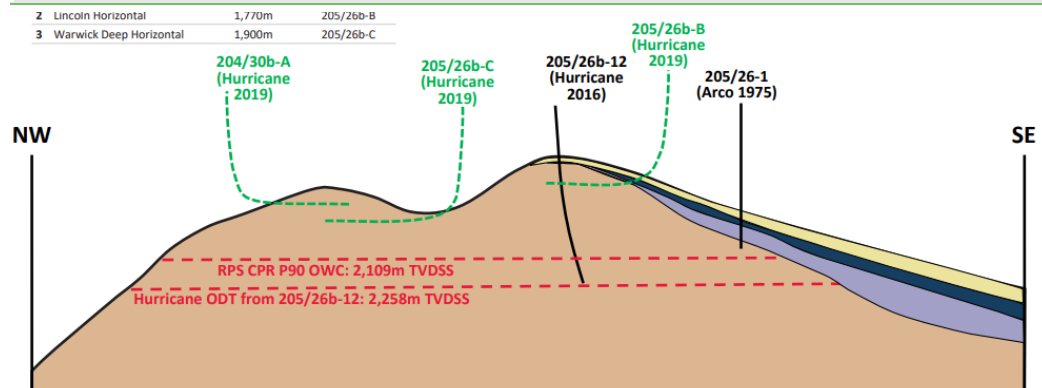


Exhibit 3: Schematic of proposed well locations (not to scale)



provide data for planning the first phase of a GWA FFD, while attributing reserves and providing cash flows.

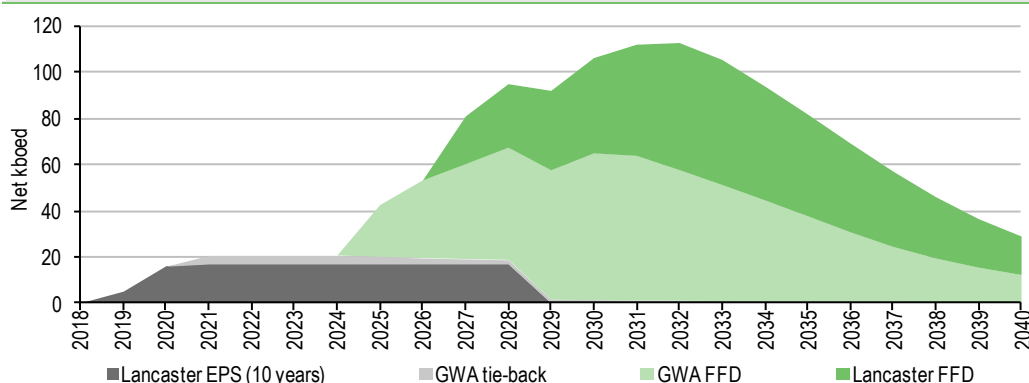
Valuation

We had assumed a farmed-out 250mmboe development for Lincoln in our [last published](#) valuation. This has now been replaced by the terms of the Spirit Energy GWA farm-in, which envisages a larger FFD for the GWA (Lincoln/Warwick) at a targeted 500mmboe gross.

Other key changes to our valuation include an upgrade to our short-term oil price assumptions, which are based on EIA figures for 2018 and 2019, at \$72.8/bbl and \$73.7/bbl. This predominantly affects our valuation of the Lancaster EPS (+3% in dollar terms), assuming first oil in H119, as our long-term oil price assumption of \$70/bbl Brent from 2022 remains unchanged.

Based on our model, we see potential for Hurricane to produce more than 100kboed net at peak, assuming a GLA and GWA resource base in line with company 2C estimates. As can be seen in Exhibit 4 below, the Spirit Energy farm-in adds a material leg to forecast net production and cash flow beyond the Lancaster EPS phase from 2024.

Exhibit 4: Modelled net production for GLA and GWA field developments*



Source: Edison Investment Research. Note: *Assumes 50% equity in GWA FFD post Spirit Energy farm-in and 46% equity in Lancaster post assumed farm-in.

Our post-transaction valuation is detailed below. We believe the market is likely applying a higher risk to GWA/GLA full field development than our current estimates in anticipation of potential de-risking, as the Lancaster EPS provides data on well productivity and basement reservoir pressure response. Recoverable resource estimates for GLA and GWA remain key areas of uncertainty; current P10 to P90 ranges remain relatively wide but are expected to narrow post the Lancaster EPS phase and further appraisal. We use 2C or mid-case prospective estimates where provided.

We include the Spirit Energy farm-in terms in our valuation as per the announced transaction, but continue to assume a farm-in for Lancaster FFD and Halifax based on an assumed farm-in partner IRR of 20%. This assumption assumes that a farm-in partner fully carries Hurricane through the development phase in return for a working interest in the project. Under our base case, Hurricane would release 54% of its equity in the FFD under our modelled transaction. The value dilution through farm-out is significantly less than 54% given the assumed cost carry, which is reflected in our valuation of Hurricane's retained equity stake. In this analysis, we assume that the farm-in partner retains the value of tax losses created from both its equity capex and carried capex, as is the case under the Spirit Energy transaction.

Edison RENAV reflects farm-in and higher 2019 oil price

Exhibit 5: Hurricane Energy valuation breakdown

Asset	Country	Diluted WI	CCoS	Recoverable reserves		NPV/boe	Net risked value	Value per share
				Gross	Net			
No of share: 2401.9**		%	%	mmboe	mmboe	\$/boe*	\$m	/share(p)
Net (debt)/cash at YE17 ex convert (assumed conversion)		100%	100%				360	11.3
SG&A (2 years)		100%	100%				(17)	(0.5)
Lancaster EPS - 10y	UK	100%	100%	57	57	13.3	766	24.0
Core NAV				57	57		1,109	34.7
Contingent								
Lancaster FFD (post-EPS)***	UK	46%	81%	451	207	6.8	1,137	35.6
Contingent RENAV				451	207		1,137	35.6
GWA tie-back (carried)		50%	72.0%	20	10	11.1	80	2.5
GWA FFD (part carried)		50%	49.0%	478	239	5.8	678	21.2
Halifax 250mmbo dev***		46%	45.0%	250	115	5.4	280	8.8
Total inc exploration RENAV				1,256	629		3,285	102.8

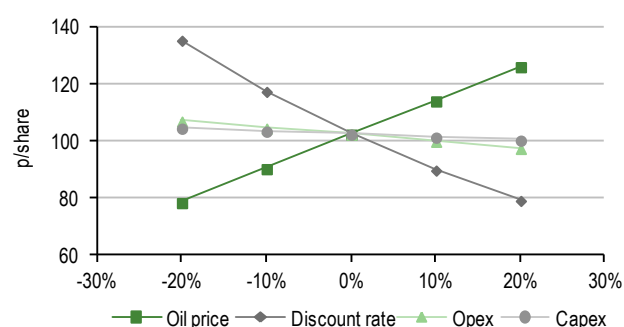
Source: Edison Investment Research. Note: *\$/boe value where we assume farm-out includes cost carry (US\$/£1.33). **Assumes conversion of convertible debt. ***Assumed farm-out at 20% farminee IRR.

Valuation sensitivities

Our valuation of Hurricane is highly sensitive to our underlying oil price assumptions. In our base case, we use the EIA's short-term forecasts (\$72.8/bbl Brent in 2018 and \$73.7/bbl in 2019) and a long-term oil price of \$70/bbl (from 2022). Below we look at the oil price sensitivity of our total risked valuation. The market appears to be either taking a conservative view on asset risking and/or implying a lower long-term oil price than Edison.

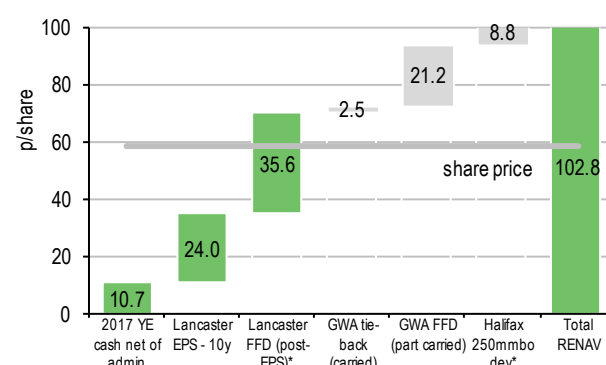
Other key valuation sensitivities include WACC and, to a lesser extent, opex and capex assumptions. We note that our valuation is relatively insensitive to capex assumptions, as we assume Lancaster EPS capex is largely fixed and, under our Lancaster FFD farm-out scenario, Hurricane is fully carried.

Exhibit 6: Hurricane risked valuation sensitivities



Source: Edison Investment Research

Exhibit 7: RENAV waterfall



Source: Edison Investment Research

Risks and sensitivities

Hurricane is subject to several sector-specific and company-specific risks. We highlight the key risks below.

Sector risks

Generic sector risks include:

- commodity price volatility;
- geological risk and uncertainty and reservoir performance uncertainty;
- recent studies on project execution in the upstream oil and gas sector suggest that up to 60% of projects incur delays and capex overruns versus FID expectations;
- small-/mid-cap availability of funding: while we include the potential dilutive impact of equity funding and farm-outs in our valuation, if the cost of capital implied by equity financing or farm-outs is higher than our estimates, this could lead to additional equity NAV/share dilution.
- volatility in service sector availability and pricing.

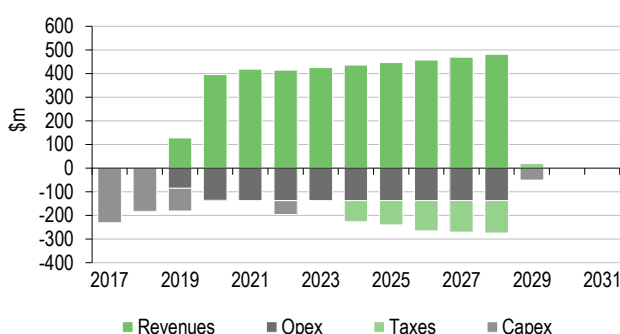
Company-specific risks

- Asset concentration: the bulk of Hurricane's value is based on one large, concentrated asset base and a play new to the UKCS (basement reservoir is a relatively less understood play compared to conventional sandstone reservoir). Hurricane's recent transaction with Spirit Energy provides an element of asset diversification, with visibility on the development of GWA as well as GLA.
- Geographical concentration: Hurricane is 100% exposed to the UKCS and petroleum fiscal terms, which have been volatile over the last decade. While tax terms and capital allowances are currently favourable versus other mature basins, there is no certainty they will not change if oil prices rise significantly from current levels, potentially reducing equity holder leverage to a rising oil price.
- Funding risks: our valuation assumes farm-out of GLA FFD in return for a development cost carry assuming a farm-in partner IRR of 20%. Value dilution through farm-out and access to developing funding for GLA FFD is explicitly assumed in our valuation.

Financials

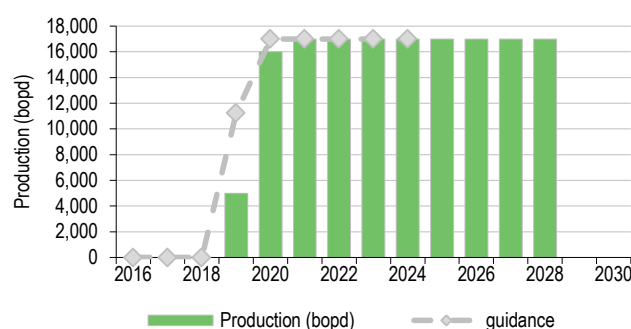
Short-term cash flow and balance sheet items are driven by Hurricane's investment in the Lancaster EPS ahead of first oil, which we model in H119.

Exhibit 8: Lancaster EPS phase development cash flows



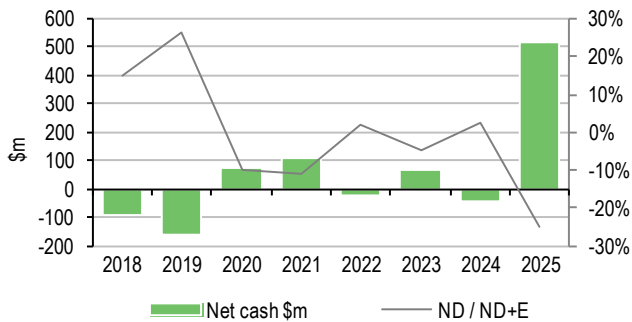
Source: Edison Investment Research

Exhibit 9: Lancaster EPS production expectations

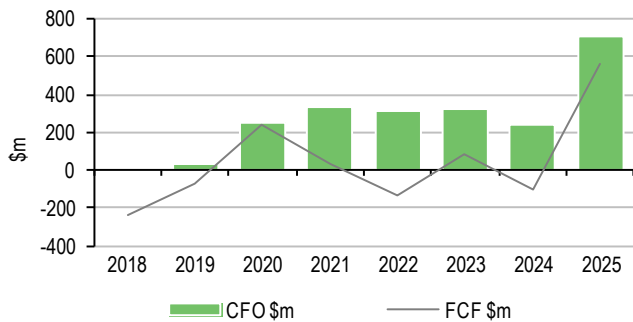


Source: Edison Investment Research

Hurricane is fully funded for the EPS phase, with contingency based on current capex forecasts. GWA exploration and appraisal (three wells) are fully carried by Spirit Energy in 2019, and GLA drilling activity is likely to be funded through Lancaster EPS cash flows in 2021. Assuming successful de-bottlenecking of the Aoka Mizu FPSO to enable 40kbod of gross production, an option exists to tie back an additional GLA producer to the FPSO, accelerating monetisation of Hurricane's GLA resource base. Indicatively, this could add c 10p/share to our valuation.

Exhibit 10: Forecast net cash and gearing


Source: Edison Investment Research

Exhibit 11: Group operating cash flow and FCF


Source: Edison Investment Research

The recent rise in oil price increases the likelihood and value retained net to Hurricane should the company look to farm out GLA full field development or appraisal of its other assets.

Hurricane remains relatively unleveraged 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.

Exhibit 12: Financial summary

US\$m	2016	2017	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS										
Revenue	0.0	0.0	0.0	128.4	396.4	510.4	506.3	519.0	531.9	1,120.2
Operating Expenses	(8.9)	(14.6)	(4.7)	(112.7)	(224.3)	(254.1)	(254.1)	(254.1)	(254.1)	(440.1)
EBITDA	(8.8)	(14.6)	(4.7)	43.2	260.0	359.9	355.8	368.4	381.4	850.8
Operating Profit (before amort. and except.)	(8.9)	(14.6)	(4.7)	15.7	172.1	256.3	252.2	264.8	277.8	680.1
Exploration expenses	0.0	(10.4)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	10.4	(70.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit	(8.9)	(14.6)	(74.9)	15.7	172.1	256.3	252.2	264.8	277.8	680.1
Net Interest	2.5	7.6	(7.6)	(14.6)	(14.6)	(14.6)	(14.6)	(14.6)	(14.6)	(14.6)
Profit Before Tax (norm)	(6.4)	(7.0)	(12.3)	1.1	157.4	241.7	237.6	250.2	263.2	665.5
Profit Before Tax (FRS 3)	(6.4)	(7.0)	(82.4)	1.1	157.4	241.7	237.6	250.2	263.2	665.5
Tax	7.3	0.0	0.0	0.0	0.0	(13.1)	(28.6)	(32.4)	(122.7)	(131.2)
Profit After Tax (norm)	0.9	(7.0)	(12.3)	1.1	157.4	228.7	209.0	217.8	140.5	534.3
Profit After Tax (FRS 3)	0.9	(7.0)	(82.4)	1.1	157.4	228.7	209.0	217.8	140.5	534.3
Average Number of Shares Outstanding (m)	889.5	1,583.8	1,958.4	1,958.4	1,958.4	1,958.4	1,958.4	1,958.4	1,958.4	1,958.4
EPS - normalised (c)	0.1	(0.4)	(0.6)	0.1	8.0	11.7	10.7	11.1	7.2	27.3
EPS - normalised and fully diluted (c)	0.1	(0.4)	(0.6)	0.1	8.0	11.7	10.7	11.1	7.2	27.3
EPS - (IFRS) (c)	0.1	(0.4)	(4.2)	0.1	8.0	11.7	10.7	11.1	7.2	27.3
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)	NA	NA	NA	12.3	43.4	50.2	49.8	51.0	52.2	60.7
EBITDA Margin (%)	NA	NA	NA	33.6	65.6	70.5	70.3	71.0	71.7	76.0
Operating Margin (before GW and except.) (%)	NA	NA	NA	12.3	43.4	50.2	49.8	51.0	52.2	60.7
BALANCE SHEET										
Fixed Assets	305.6	587.9	859.8	928.8	850.9	1,048.8	1,387.7	1,518.9	1,765.3	1,739.3
Intangible Assets	302.5	126.4	127.7	127.7	127.7	127.7	127.7	127.7	127.7	127.7
Tangible Assets	0.0	445.3	724.5	793.5	715.6	913.5	1,252.3	1,383.6	1,630.0	1,604.0
Investments	3.0	16.3	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Current Assets	106.3	350.1	111.2	43.3	278.7	309.5	179.6	266.2	160.3	720.6
Stocks	0.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Debtors	7.3	4.7	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
Cash	98.6	343.9	104.2	36.3	271.6	302.5	172.6	259.2	153.3	713.5
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(26.3)	(28.8)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)
Creditors	(26.3)	(28.8)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)	(51.5)
Short term borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(6.0)	(226.7)	(317.0)	(317.0)	(317.0)	(317.0)	(317.0)	(317.0)	(317.0)	(317.0)
Long term borrowings	0.0	(191.1)	(194.5)	(194.5)	(194.5)	(194.5)	(194.5)	(194.5)	(194.5)	(194.5)
Other long term liabilities	(6.0)	(35.6)	(122.5)	(122.5)	(122.5)	(122.5)	(122.5)	(122.5)	(122.5)	(122.5)
Net Assets	379.6	682.5	602.5	603.6	761.1	989.8	1,198.8	1,416.6	1,557.1	2,091.3
CASH FLOW										
Operating Cash Flow	(5.6)	(8.1)	(10.1)	28.6	245.3	332.3	312.6	321.4	244.1	705.0
Cash tax paid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capex*	(63.5)	(265.7)	(229.6)	(96.5)	(10.0)	(301.5)	(442.5)	(234.9)	(350.0)	(144.7)
Acquisitions/disposals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	160.6	301.2	(6.7)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow	91.5	27.4	(246.4)	(67.9)	235.3	30.8	(129.9)	86.6	(105.9)	560.3
Opening net debt/(cash)	(11.3)	(98.1)	(133.5)	114.9	182.8	(52.5)	(83.3)	46.5	(40.0)	65.9
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	(4.7)	8.0	(2.1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Closing net debt/(cash)	(98.1)	(133.5)	114.9	182.8	(52.5)	(83.3)	46.5	(40.0)	65.9	(494.4)

Source: Company accounts, Edison Investment Research. Note: *Includes net capex for GWA wells and FFD after carry and assumes farm-out of GLA for full development carry using a farminee 20% IRR.

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