Put High Arctic Energy Services on Your Radar

Description

High Arctic Energy Services (TSX: HWO) has operations throughout Western Canada and in Papua New Guinea (PNG). The combination of a well-positioned Canadian business, exciting growth opportunities in PNG, a rock bottom valuation and enticing yield make this one attractive looking stock. To find out if it's too good to be true, let's check out the company's strengths, weaknesses, opportunities and threats.

Strengths

Consistent Revenue and EBITDA Growth: The company's PNG operations have helped to offset lower activity levels in Canada. In 2012, year-over-year revenue growth checked in at 15%, and adjusted EBITDA climbed 19% over this same period. This trend continued in Q1 2013 when revenue and EBITDA grew 15% and 26% respectively, compared to Q4 2012.

Consistent Operating Cash Flow (CF) Growth: For 2012, CF increased 17% compared to 2011. This uptrend didn't change in Q1 2013 when operating CF grew another 29% compared to Q4 2012. Continued modest growth is expected to continue as the company recently announced a 3-year contract extension with its primary customer/partner in PNG.

Low Competition in PNG: High Arctic is one of only a handful of companies that operates in an extensive and highly undeveloped resource play in PNG. This gives High Arctic pricing power which is a significant tailwind for its future business in this country.

Dominant Player in Niche Market in Canada: With a 24% market share, High Arctic owns Canada's largest fleet of stand alone snubbing units. Snubbing is a necessary service for the majority of newly drilled, high pressure, oil and liquids rich wells.

Reliable customers: The company's primary customer is Oil Search Limited (OSL), an Australian company with an $8.5 billion market cap. Oil Search is PNG's largest producer and most active operator. PNG's government is one of OSL's largest shareholders, holding 15% of OSL's outstanding shares. OSL operates all of PNG's currently producing oil and gas fields, and owns a 29% stake in the $19.0 billion Exxon LNG project. Other customers include Interoil, Talisman, Exxon, Eni and Encana.

Hefty dividend: High Arctic pays a monthly dividend with an annual yield of ~7%. The dividend totals approximately $7.5 million for 2013. Including the CapEx, the total pay-out ratio is below 100%.

2013 CapEx Funded By Cash Flow And Cash On Hand: 2013 CapEx of $32 million will be funded from operating cash flow and cash on hand. This helps the company maintain its strong balance sheet without increasing its bank debt.

Low Multiples: The stock carries a low PE of ~3x earnings for 2013 and my estimate is that High Arctic will have ~45 million EBITDA this year. With Enterprise Value (EV) at $95 million currently, the company trades at a low EV/EBITDA multiple versus its peers as shown at the table below:

Company	**P/BV**	**EV ($M)**	**EBITDA ($M) (annualized)**	**EV/EBITDA**
Xtreme Drilling (TSX:XDC)	0.7	362	77	4.7
High Arctic	1.0	95	45	2.1
Trinidad Drilling (TSX:TDG)	1.0	1,427	340	4.2
Precision Drilling (TSX:PD)	1.1	3,656	860	4.2
Ensign Energy Services (TSX:ESI)	1.3	3,014	673	4.5

All four of these peers operate in Canada and abroad, providing a wide range of oilfield services.

Strong Operating and EBITDA margins: These margins have been consistently strong. The operating margin was at 22% in Q1 2013, compared to 20% and 19% for 2012 and 2011 respectively. The EBITDA margin was at 28% in Q1 2013, compared to 27% and 26% for 2012 and 2011 respectively.

Concentrated Ownership: According to Capital IQ, 62.5% of the company is owned by two parties. New York based Cyrus Capital Partners' owns 42.5% and Jed Wood, the founder and former CEO, owns ~20%. Jed Wood is the founder and former CEO of the company.

Weaknesses

Illiquidity: The stock has low liquidity. While the market cap is ~$103 million currently, the free float is only ~$26 million. This makes it difficult for institutional investors to establish a substantial position in this name.

Temporarily Slow PNG activity: The construction of an LNG plant in PNG might temporarily slow the company's growth in 2013. The capital demands of this project affect the capital available for drilling in the near term. This anticipated slower drilling activity in 2013 will likely reduce demand for new rental equipment in 2013.

Decreasing Canadian activity: In Canada, the company has seen year over year declines in Q1 2013 due to persistent weak natural gas prices and transportation bottlenecks for Alberta crude oil. The start of the 2013 winter drilling season saw drilling rig activity levels down approximately 10% from the start of the 2012 season. This trend will likely remain for the remainder of 2013.

Opportunities

Growth Prospects in PNG: They include investing further in matting and purchasing additional ancillary support equipment along with specialized drilling tools. High Arctic expects to be busy in PNG over the next 30 years thanks primarily to the LNG facility. **Exxon Mobil**, OSL and several other partners are currently building an LNG export facility in PNG that is scheduled to come on stream in 2014. High Arctic is well positioned to deliver the services required by OSL to both continue its oil drilling program that will offset natural declines and to drill for new gas reserves that will be required as feedstock for any additional trains added to the LNG facility.

Growth Prospects in Canada: Liquids rich gas play developments primarily in the Duvernay and Montney are expected to remain strong as producers focus on the reservoirs offering the highest liquids content.

Acquisition Scenario: Although it's, it isn't unrealistic to assume that the company will be acquired by a larger entity which wants to expand its footprint in PNG.

Threats

Political and Operational Environment in PNG: Although PNG has an established democracy with its judicial and court systems being modeled after the Australian ones, there is a degree of political instability which has to be taken into consideration. The operating conditions in PNG are also a definite consideration because the terrain is very challenging.

Foolish Bottom Line

High Arctic offers solid long-term prospects, particularly for the bargain basement valuation affixed to the shares currently. The positives clearly outweigh the negatives, and you are paid to wait until the market gives High Arctic a fair valuation.

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CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HWO (High Arctic Energy Services Inc)

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