INDUSTRY NOTE
December 2, 2018

Oil Service

9th Annual Private Company Conference Recap

CONCLUSION

We recently convened for our 9th Annual Private Energy Conference, an event which continues to attract many of the leading private oil service enterprises. This year was no exception with over fifty attending companies journeying to New York City to discuss leading industry trends. Timing of this event, as usual, provided a helpful road-map in understanding near-term seasonal trends, while market candor, a key attribute to this conference, distilled into an open discussion of the issues confronting the industry with some commentary a bit jarring. Interestingly, however, while most presenting companies presented company-specific growth ambitions which would point to an improved 2019, such growth ambitions in the face of ~$50 WTI will potentially weigh on the overall sector – we'll elaborate later in this note.

Yet the most salient consideration is not the bevy of pricing, utilization, and capacity expansion anecdotes arising from the conference , but rather the decisions made in the coming days when OPEC meets. Should a formal agreement yield production cuts in the vicinity of ~1.0-1.5 MBD, likely resulting in higher oil prices, then the growth plans surfacing from our private industry friends, which are admittedly bearish for our coverage universe, should be less concerning. If, however, OPEC fails to reach an accord and oil prices slide below $50/bbl, industry overcapacity challenges will be exacerbated and likely lead some OFS sub-segments to quickly move towards EBITDA break-even.

Such an outcome is the consequence of deconsolidated, low barrier-to-entry businesses and one of the many reasons why industry consolidation is so desperately needed. If industry leaders fail to appreciate this possibility, we may very well be faced with the reality of another round of bankruptcies/corporate restructurings thus evaporating what little equity value presently exists for some enterprises today. Let's hope OPEC acts responsibly and remain prayerful for industry consolidation.

Panelists from pressure pumping, wireline, well servicing and frac sand all report recent pricing declines. Essentially only land drilling and compression players see stable-to-improving pricing. Declines of ~10% were reported within well service and wireline while one frac company stated some spot marketing pricing has moved to break-even levels and an operator noted an ability to reach long-term frac pricing agreements near current spot rates. To be fair, it is not clear how widespread these concessions are, but in a $50 WTI world, these cuts are likely just the beginning. In fact, one panelist opined it could see another 5-10% pricing cut should low oil prices persist.

At the same time, labor markets are generally viewed as tight (albeit not as bad as a year ago) and companies are generally hopeful for better activity in 2019, thus we suspect little effort is being made to trim costs. If this theory holds true, there is potential for steep margin declines. Moreover, while we suspect most energy investors are aware of the existing supply/demand challenges facing the frac market, we suspect less attention is being paid to smaller segments such as wireline and well servicing, thus growing pricing tension in these businesses is new news – a risk to SMID names with exposure to one or both of these product lines (i.e. PES, KEG, BAS, NINE, CJ, SPN, RNGR, etc.). Again, we emphasize the concessions highlighted last week are very recent and very select anecdotes. But the implication is stark: our models assume flat-to-slightly higher pricing for these two segments next year.

John Daniel
Sr. Research Analyst, Piper Jaffray & Co.
713 546-7215, john.m.daniel@simmonspjc.com
John Watson, CFA
Sr. Research Analyst, Piper Jaffray & Co.
713 546-7256,
john.h.watson@simmonspjc.com
Bill Herbert
Sr. Research Analyst, Piper Jaffray & Co.
713 546-7203,
william.a.herbert@simmonspjc.com
Dylan G. Glosser
Research Analyst, Piper Jaffray & Co.
713 546-7206,
dylan.g.glosser@simmonspjc.com
Ben A. Carl
Research Analyst, Piper Jaffray & Co.
713 546-7282, ben.a.carl@simmonspjc.com
Patrick J. Flam
Research Analyst, Piper Jaffray & Co.
713 546-7223, patrick.j.flam@simmonspjc.com

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INDUSTRY RISKS

Cannibalized equipment, costs of rebuilds, and the oversupply of frac fleets. The oversupply of frac sand and the potential for declining service intensity.

New Capacity Expansion Continues

Multiple panelists will continue to expand operations into 2019, in part given strong customer relationships and an expectation new capacity will displace incumbent providers. All three of our frac panelists intend to deploy new fleets next year with Pro Frac Services committed to reaching 1.5M horsepower (17 fleets today with 13 on the way). Alamo is running six fleets with plans to build 4-6 more in 2019 while Evolution will soon operate three fleets with another three fleets expected to be delivered in 2019. In total, we believe the U.S. frac market will build another ~1.7M horsepower in 2019, but some of this capacity will likely be destined for replacement purposes. Nonetheless, the expansion in the face of declining pricing and lower utilization is a concern.

Yet, each of these companies has a rationale for growth. In one case, the company plans to “inflict pain” on its perceived lesser competition made possible in part due to its reduced newbuild fleet cost ($25-30M); in another case, the company's customers value the new, more reliable equipment; and in the final case, new technology leads to reduced well costs. For one of the frac companies, its expansion plans are expected to lead customers to replace existing frac providers. Two of the panelists' strategy is to deploy its new equipment for pad work, displacing competitors with less well maintained pumps to single well jobs.

Within wireline, both of our panelists will add new capacity and for well servicing, each company will add more pump horsepower to target completion-oriented work, although no new rig orders are planned. The land drilling panelist enjoys 100% utilization including for its SCR rigs with average dayrates across its fleet of $20-25k. We suspect some new rigs will be built by this player. Lastly a compression player will increase its capacity by ~30% next year, the majority of which is already contracted evidencing the relative strength of the compression market as well as elevated demand for gas lift.

Disruptive Technologies Emerging

Our conference featured several panelists (as well as audience members) who have recently introduced new products to market. We view these product innovations as disruptive. First, Evolution Well Services, a pure-play provider of electric frac technology, is now running three fleets and will soon have three more delivered with inquiries for more fleets in the pipeline. Costs to build the fleets were characterized at nearly $800/hp, essentially in-line with Tier 4 fleets. Move times on the current fleet design have been reduced from three days to 13 hours while the crew size of ~12 along with clean emissions, limited noise pollution and a smaller footprint (only 8 pumps required – total of 56,000hp combined) are virtues of the Evolution design. Presently, we believe three companies provide electric fleets (Evolution, U.S. Well Services and according to field reports – Topps Well Service in the PRB). One panelist – Enquest Energy Solutions, an emerging frac capital equipment packager – reports interest in electric fleets from other potential players is growing. Enquest believes potentially three other entities are evaluating the technology today.

Another new design – and one we profiled earlier this year – is the new fluid end offered by Kerr Pumps. This fluid end (F1 Connect) is priced at $49,995 – this compares to pricing in the low $60k range for many competitor offerings. The company claims a traditional steel forging can yield two F1 Connect fluid ends vs. only one fluid end using the more traditional design, thus it could potentially take its pricing into the low $30k range (we don’t suspect this happens, however). While we cannot independently verify the quality of this product, Kerr noted its volumes are up y/y in 2018 and given growing demand, it expects to see higher volumes in 2019, potentially requiring further plant expansion. Should pricing for fluid ends move closer towards the Kerr price across the industry, it could create an issue for select capital equipment providers, but conversely would be a benefit to our frac universe. As would the elongation of average fluid end life to over one year, perhaps enabling more frac companies to capitalize fluid ends.

An emerging last mile logistics player, not featured on a panel, reports it is ahead of plan with its new system introduction and sees its activity growing next year while Pegasus Optimization Managers mentioned its new business unit Pegasus EOR which provides EOR solutions to clients using specialized compressors.

PPS Utilization Template

Our PPS supply/demand template is a living, breathing document which is seemingly in need of update following every conference, earnings season and/or field trip. In light of comments made at our Private Company conference as well as to tweak certain operating assumptions, we have once again refreshed our template. At the conference, one operator noted improving frac efficiencies by decreasing its mobilization times, standardizing its frac design, and decoupling services (it sometimes prefers small service providers to very large ones). Our revisions attempt to account for improving frac efficiencies, biasing our demand estimates lower.

We presently believe U.S. frac demand stands at ~16-17M horsepower (on a base of 23.7M, including marketed/idle), representing demand in the vicinity of 360-390 fleets assuming 45,000 horsepower per average fleet. For those who employ a HZ rig/frac fleet ratio as the basis for deriving demand, the implied demand using a ~1,000 HZ rig count with a 2.5x to 3.0x HZ rig/fleet ratio would be somewhere in the range of 333 to 400 fleets. Meanwhile, industry contacts have suggested the U.S. active fleet stands at nearly 370 fleets, so collectively these different measures triangulate reasonably well, particularly if one uses the mid-points of the first two methodologies.

Our current land rig forecast is based on a low $60 WTI environment. This assumption may be called into question if OPEC doesn't cut; however, for now, we will maintain our working view. Under this framework, we believe the U.S. drilling rig count could rise to nearly 1,200 rigs in 2020, up from today's count at 1,053 rigs. Making some assumptions for continued efficiency gains leads us to estimate frac horsepower demand rising to 20.0M to 21.0M horsepower or roughly 425 to 450 fleets in 2020. Employing a 2.50x to 3.0x HZ rig/fleet ratio suggests required fleets would be somewhere in the 375 to 450 range.

If the market did not order any more fleets above and beyond our current newbuild tally (highly unlikely), this would imply a total U.S. marketed fleet of ~25.5M horsepower implying overall utilization in the low 80% range. In other words, a 1,200 rig count environment (of which just over 1,100 are HZ), coupled with a presumed desire by E&P's to work through the growing DUC count, should lead to improved frac demand and a tightening frac market. Unfortunately, growing new supply likely suppresses an industry pricing recovery, although consolidation, if it were to happen in scale, would offset this headwind.

Other

For one completions-oriented player, October 2018 was the worst month of 2H'18. It expects improved results in November. Pricing for casing and tubular running as well as well flow management seems to have held up reasonably well relative to other business lines. Lastly, a number of players mentioned growing activity in both the Haynesville and the Austin Chalk, a potential trend worth monitoring heading into 2019.

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Analyst Certification — John Daniel, Sr. Research Analyst
— John Watson, CFA, Sr. Research Analyst
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Time of dissemination: 2 December 2018 18:23EST.

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