Reloading the event book (2)

MAY 24, 2022 / PUPPYEH / EDIT

Continuing on with my mini event-related series. Unfortunately this name is nowhere near as liquid as I would like and thus it is sized accordingly (ie smaller). That said it is fairly compelling and I believe quite actionable near-term so I will include it here (briefly – feel free to ask any follow-ups in the Q&A).

Unit Corp (US OTC: UNTC, UNTCW for the warrants) – last price $55 – $500k ADV for the stock, $100k ADV for the warrants

Unit Corp is an odd-ball collection of oil & gas related assets that emerged from bankruptcy mid last year. It has been written up here on VIC (in the public domain); and by my friend Andrew Walker more recently here (but I believe this is paywalled – you should all subscribe to YAVB, it is incredible quality and well worth the annual sub!). Since this is illiquid I will offer brief thoughts on the setup. This will not be a deep-dive into the well-head economics, or a geological analysis of the company's producing fields.

At a very high level this a break-up/asset sale for a bunch of assets, at or near market peaks where the market is asleep at the wheel because it is a post-BK OTC-listed stock and/or far too skeptical that value can be realized. **The stock trades at $55.5, whereas**

a conservative measure of SoTP fair value is probably double that and not unrealistically 1.5x the current quote. Unlike many other SoTP stories, the company is actively running a process to dispose of their main asset – their producing O&G assets – that, if consummated, will return >$70-80+ per share in net cash against a totally unlevered $55 stock today. After they sell O&G, the remaining pieces are much smaller relatively, and one of the two pieces left has an obvious sales timeline built into it via a contract 'kick out' clause in April, 2023 – meaning the whole thing is likely unwound in the next 12-18 months. But given the degree of discount and the company's propensity to return capital accretively, I don't think you need a full sale of O&G to do very well here.

Personally I own both the stock and the warrants ($63.74 strike, Sep'27 expiry), but a lot more of the warrants, as you gain a lot more leverage to SoTP realization; the liquidity of both instruments is comparable; and the underlying entity is (I believe) about to be incredibly cash rich, defraying downside risk on the option value (which is itself quite long-dated at 5+ years). Still, I will address the pros and cons of both instruments shortly.

If you read the VIC write-up, you will note UNTC consists of three main pieces: the O&G assets ('Unit Petroleum'); a drilling business ('Unit Drilling'); and a 50% junior subordinated stake in a Midstream pipeline/gathering company, Superior. Let's take a quick spin through each asset.

Unit Petroleum: up for sale and more than covers the current market cap

Unit Petroleum (UPC) is a collection of producing and undeveloped acreage, mostly in Oklahoma and Texas. They control ~1.5k net producing wells across 336k acres, with >85% operatorship, predominantly gas and NGL focused but with some oil as well. PDP reserves (proven and developed) are enough for ~5-6 years of production at current decline rates; the company has hedged up most of 2022 oil and gas production (but not NGLs) at much, much lower levels, and maybe ~50% of 2023 oil/gas production (but again not NGLs). Despite these (in hindsight) inopportune hedges, UPC did $60mm of EBIT in 1Q alone:

The following tables provide certain information about the operations of each of our segments:

	Three Months Ended March 31, 2022					
	Oil and Natural Gas	Contract Drilling	Mid-Stream [2]	Corporate and Other	Eliminations [2]	Total Consolidated
	(In thousands)					
Revenues: [1]						
Oil and natural gas	$ 87,582	$ —	$ —	$ —	$ (10,772)	$ 76,810
Contract drilling	—	28,882	—	—	—	28,882
Gas gathering and processing	—	—	83,198	—	(525)	82,673
Total revenues	87,582	28,882	83,198	—	(11,297)	188,365
Expenses:						
Operating costs:						
Oil and natural gas	24,000	—	—	—	(525)	23,475
Contract drilling	—	26,237	—	—	—	26,237
Gas gathering and processing	—	—	73,771	—	(11,383)	62,388
Total operating costs	24,000	26,237	73,771	—	(11,908)	112,100
Depreciation, depletion, and amortization	4,048	1,534	5,614	74	—	11,270
Total expenses	28,048	27,771	79,385	74	(11,908)	123,370
General and administrative	—	—	—	5,915	611	6,526
(Gain) loss on disposition of assets	(53)	(2,125)	—	3	—	(2,175)
Income (loss) from operations	59,587	3,236	3,813	(5,992)	—	60,644
Loss on derivatives	—	—	—	(64,076)	—	(64,076)
Loss on change in fair value of warrants	—	—	—	(36,612)	—	(36,612)
Loss on deconsolidation of Superior	—	—	—	(13,141)	—	(13,141)
Reorganization items, net	—	—	—	(3)	—	(3)
Interest, net	—	—	(178)	(96)	—	(274)
Other	708	20	17	12	—	757
Income (loss) before income taxes	$ 60,295	$ 3,256	$ 3,652	$ (119,908)	$ —	$ (52,705)

This excludes the mark-to-market hit of remarking the hedge book to higher strip prices, but you can see this EBIT was generated from much lower realized prices than

BRL.AX BWMX CLMT CNE.LN CVN.AX DXLG E2N eml.ax EVO.AX FAR.AX GAN hdg.na HRBR IDA.AX INTL KAR.AX LMN MBR MET.NZ MFD.AX NIO NLOP PAC.AX PBIT.TO PTEC.LN RE4.SI SAVE SF3.DE SHVA.TA SMR.AX SNEX SQZ.LN tnk.ax TRQ TWTR UNTC URF.AX WOW WRKS.LN WTE

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spot (the cash-flow impact of meeting the hedges). Most of the heavy lifting was thus done by NGLs (unhedged, where prices have rallied along with the oil and gas curve):

Results of Operations

Three months ended March 31, 2022 versus three months ended March 31, 2021

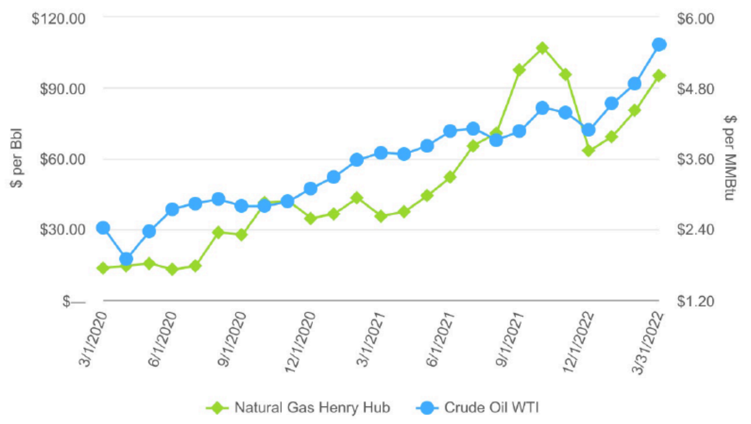
Provided below is a comparison of selected operating and financial data:

	Three Months Ended March 31,			
	2022	**2021**	**Change**	**Percent Change (1)**
	(In thousands unless otherwise specified)			
Total revenue, before inter-segment eliminations	$ 199,662	$ 130,309	$ 69,353	53 %
Total revenue, after inter-segment eliminations	$ 188,365	$ 120,897	$ 67,468	56 %
Net income (loss)	$ (52,705)	$ (591)	$ (52,114)	NM
Net income (loss) attributable to non-controlling interest	$ (5,828)	$ 1,346	$ (7,174)	NM
Net loss attributable to Unit Corporation	$ (46,877)	$ (1,937)	$ (44,940)	NM
Oil and Natural Gas:				
Revenue, before inter-segment eliminations	$ 87,582	$ 55,024	$ 32,558	59 %
Operating costs, before inter-segment eliminations	$ 24,000	$ 19,993	$ 4,007	20 %
Average oil price (Bbl)	$ 59.72	$ 47.29	$ 12.43	26 %
Average oil price excluding derivatives (Bbl)	$ 92.22	$ 56.12	$ 36.10	64 %
Average NGLs price (Bbl)	$ 32.91	$ 17.96	$ 14.95	83 %
Average NGLs price excluding derivatives (Bbl)	$ 32.91	$ 17.96	$ 14.95	83 %
Average natural gas price (Mcf)	$ 3.31	$ 2.77	$ 0.54	19 %
Average natural gas price excluding derivatives (Mcf)	$ 4.54	$ 2.72	$ 1.82	67 %
Oil production (MBbls)	406	413	(7)	(2) %
NGL production (MBbls)	613	641	(28)	(4) %
Natural gas production (MMcf)	6,514	7,403	(889)	(12) %
Contract Drilling:				

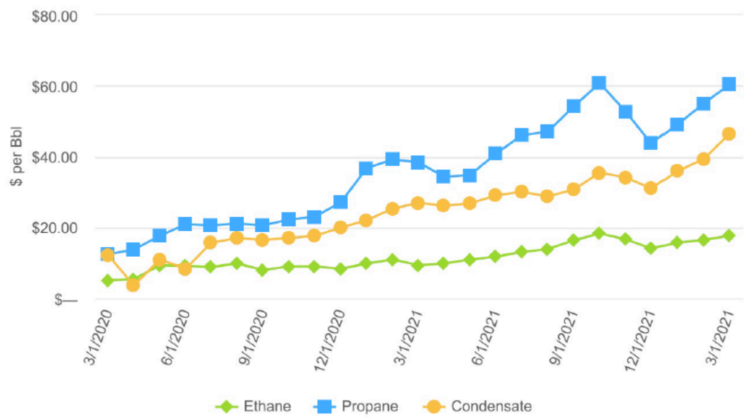
So UPC alone is doing ~$60mm of EBIT, hedged, per quarter, or *$240mm annualized (a fudge given declines but let's go with it for now) against a market cap today of $550mm and an EV of $490mm* (they have $88mm net cash but $25mm of AROs) – all in the context of over half their production hedged at much lower levels. Obviously with WTI above $110 and nat gas above $8, these numbers explode in the event the curve shape holds (a huge if).

I mention these run-rate earnings and cashflow-generating numbers to give a sense of the current earnings power of the asset. But the key catalyst is UNTC is running a full sales process for the Petroleum business – a business where January PV10 was $765mm and where Reuters was reporting the company was asking for $1bn. Note that, as UNTC describes in its 1Q report, prices for oil/nat gas/NGLs have done this lately:

November 2023 (14)
October 2023 (11)
September 2023 (9)
August 2023 (10)
July 2023 (12)
June 2023 (11)
May 2023 (12)
April 2023 (9)
March 2023 (14)
February 2023 (13)
January 2023 (11)
December 2022 (6)
November 2022 (9)
October 2022 (7)
September 2022 (7)
August 2022 (10)
July 2022 (8)
June 2022 (8)
May 2022 (10)
April 2022 (7)
March 2022 (7)
February 2022 (7)
January 2022 (7)
December 2021 (5)
November 2021 (8)
October 2021 (7)
September 2021 (6)



The following chart reflects the significant fluctuations in the prices for NGLs:



If PV10 was $765mm in January, it stands to reason the number is far, far higher today – probably north of $1bn, maybe significantly so. As per UNTC's latest disclosures, this sales process remains 'ongoing':

> ***Oil and Natural Gas***
>
> The company initiated an asset divestiture program at the beginning of 2021 to sell certain non-core oil and gas properties and reserves (the "Divestiture Program"). On October 4, 2021, the company announced that it is expanding the Divestiture Program to now include the potential sale of additional properties, including up to all of UPC's oil and gas properties and reserves. On January 20, 2022, the company announced that it has retained a financial advisor and launched the process, which is still ongoing.

The real question is, can a deal be consummated and what is the right price. If this question were posed in January, I would have probably answered $500-550mm (since you would expect some discount to PV10, nothing trades at PV10 in this price environment), but with the value in the ground up so much I would think $800mm++ is very achievable now – probably still only 70% of 2P PV10 and getting all the undeveloped acreage ('1P') for free. Gas and oil prices have been moving so fast, no doubt it is proving difficult to nail down a number. But given these continuous disclosures and the fact that the company appears clearly, in other ways, to be brushing itself up for a sale, I think either a full or partial sale of the O&G asset could be announced very soon.

That announcement, should it come, would likely clarify a >$85/share purchase price (at $850mm gross, since there are 10.05mm shares out), with likely minimal or no tax leakage (since UNTC has ~$400mm of NOLs), partially offset by ~$100mm in hedges. *I believe the net number to UNTC shareholders would thus be somewhere around $75/share,* free and clear of all residual liabilities.

Unit Drilling: hidden asset about to inflect, probably also in play

Outside of UPC, Unit has a drilling business, consisting of 21 high-spec land-based drilling rigs that operate at various utilizations both for UPC assets and third-parties. These assets are on the books at ~$67mm per the accounts…

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

UNIT CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 31, 2022	December 31, 2021
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 88,259	$ 64,140
Accounts receivable, net of allowance for credit losses of $2,482 and $2,511 as of March 31, 2022 and December 31, 2021, respectively	58,583	87,248
Prepaid expenses and other	3,024	5,542
Total current assets	149,866	156,930
Property and equipment:		
Oil and natural gas properties, on the full cost method:		
Proved properties	220,754	225,014
Unproved properties not being amortized	5,317	422
Drilling equipment	66,983	66,058
Gas gathering and processing equipment	—	274,748
Transportation equipment	1,826	4,550
Other	8,631	8,631
	303,511	579,423
Less accumulated depreciation, depletion, amortization, and impairment	80,694	128,880
Net property and equipment	222,817	450,543
Equity method investment (Note 15)	1,658	—
Right of use asset (Note 14)	8,151	12,445
Other assets	7,093	9,559
Total assets [1]	$ 389,585	$ 629,477

1. Unit Corporation no longer consolidates the balance sheet of Superior Pipeline Company, L.L.C. (Superior) as of March 31, 2022 as discussed in Note 2 - Summary Of Significant Accounting Policies and Note 15 - Superior Investment. Unit Corporation's consolidated total assets as of December 31, 2021 include current and long-term assets of Superior of $61.1 million and $229.5 million, respectively, which can only be used to settle obligations of Superior. Unit Corporation's consolidated cash and cash equivalents of $64.1 million as of December 31, 2021 includes $17.2 million held by Superior.

…even though 15 of the rigs are high-spec 'BOSS' rigs that cost $20mm new. There is an active secondary market for rigs, where apparently these trade at ~$5-10mm per as well. More importantly, the trend in land-based drilling is incredibly favorable, and this segment could be making real earnings power imminently (it made ~$15mm EBITDA last year so not much). Consider that utilization improved every quarter in 2021:

The following table shows the average number of our drilling rigs working by quarter for the years indicated:

	2021	2020
First quarter	9.4	18.7
Second quarter	10.0	9.1
Third quarter	11.0	5.1
Fourth quarter	13.2	7.6

…and jumped up again to >15 in 1Q, even though day-rates are still pretty low at <$20k (whilst the company website suggests 17 are operating today):

Natural gas production (MMcf)		6,514		7,403		(889)	(12)	%
Contract Drilling:								
Revenue, before inter-segment eliminations	$	28,882	$	15,674	$	13,208	84	%
Operating costs, before inter-segment eliminations	$	26,237	$	11,871	$	14,366	121	%
Average number of drilling rigs in use		15.5		9.4		6.1	65	%
Total drilling rigs available for use at the end of the period		21		21		—	—	%
Average dayrate on daywork contracts	$	19,756	$	18,127	$	1,629	9	%
Mid-Stream: (2)								

Anecdotally, these kinds of rigs are currently being quoted at $27-29k/day in Texas, according to some sources I have discussed the market with, and whilst no doubt costs are going up aggressively too, basically all the larger listed drillers are talking up utilization and a coming boom in day-rates for these kinds of drills. Take these comments from Patterson-UTI, for example:

William Hendricks

Thanks, Mike. Good morning, and welcome to Patterson-UTI's first quarter conference call. Thank you for joining us today.

I am very pleased with our first quarter results, especially within contract drilling, where our better-than-expected revenue per day during the quarter illustrates how quickly day rates are increasing. Our average adjusted margin in the U.S. increased by $1,720 per day in the first quarter, and we expect further margin growth in the second quarter of an additional $1,100 per day, driven by a $1,600 increase in average rig revenue per day. For perspective, this is the strongest daily margin growth we have seen since 2013 and 2014.

The base leading-edge day rates for Tier 1 rigs is now in the upper $20,000 and, including ancillary equipment, easily over $30,000 per day at the leading edge, driven by increasing demand and a limited supply of readily available rigs. With the tight market, some customers are already planning for their additional needs in 2023, which we expect to drive demand for longer-term contracts and also increase contract backlog. We are also seeing significant price increases for our services in both pressure pumping and directional drilling. And in our pressure pumping business, we are obtaining more favorable standby terms to help offset customer-related downtime.

The market is really sleeping on the ability of the Drilling segment to move the needle here. At say 17-20 rigs average utilization; $25k/day dayrate; 85% uptime and 60% incremental EBITDA margins, Unit ***Drilling could be looking at ~$50-75mm of annual EBITDA from this unit alone:***

July 2016 (1)
March 2016 (1)
February 2016 (2)
December 2015 (1)
October 2015 (1)
September 2015 (2)
August 2015 (3)
July 2015 (1)
June 2015 (1)
May 2015 (2)
April 2015 (4)
March 2015 (6)

	2022	2023
Avg rigs utilized	17	20
Dayrate	25000	28000
Uptime	85%	85%
Revenue days	310	310
Total revenues ($mm)	132	174
2021 revenues	76	76
Incremental revenues	56	98
Incremental EBITDA AT 60% margin	34	59
Total segment EBITDA ($mm)	**49**	**74**

Thus, even at a very low multiple of (presumably) peakish earnings, it is hard to see how this segment isn't worth close enough to the replacement value of the rigs plus one year of cash flow – call it $150-200mm – and probably more to an acquirer like H&P or Patterson UTI who could simply plug in these scarce rigs to an active fleet. That's another $15-20/share of net value to UNTC shareholders.

Superior Midstream: another asset being set up for sale

Superior, the midstream pipeline asset, is a bit of a complicated beast because UNTC sold 50% in 2018, for $300mm – but via a rather convoluted partnership agreement that gave preferential distribution rights, and IRR thresholds, to their JV partner. Here is what the 10-K has to say about it:

NOTE 20 – VARIABLE INTEREST ENTITIES

On April 3, 2018, we sold 50% of the ownership interest in Superior. The 50% interest in Superior we sold was acquired by SP Investor, a holding company jointly owned by OPTrust and funds managed and/or advised by Partners Group, a global private markets investment manager. Superior is governed and managed under the Amended and Restated Limited Liability Company Agreement (Agreement) and MSA. The MSA is between our wholly-owned subsidiary, SPC Midstream Operating, L.L.C. (the Operator) and Superior. As the Operator, we provide services, such as operations and maintenance support, accounting, legal, and human resources to Superior for a monthly service fee of $0.3 million. Superior's creditors have no recourse to our general credit. Unit is not a party to and does not guarantee Superior's credit agreement. The obligations under Superior's credit agreement are secured by, among other things, mortgage liens on certain of Superior's processing plants and gathering systems.

We have determined that Superior is a VIE as the equity holders as a group (Unit Corporation and SP Investor) (Members) lack the power to control without the Operator. The Agreement and MSA give us the power to direct the activities that most significantly affect Superior's operating performance through common control of the Operator. Accordingly, Unit is considered the primary beneficiary and consolidates the financial position, operating results, and cash flows of Superior.

The Agreement specifies how future distributions are to be allocated among the Members. Distributions from Available Cash (as defined in the Agreement) were generally split evenly between the Members prior to December 31, 2021, when the three-year period for Unit's commitment to spend $150.0 million (Drilling Commitment Amount) to drill wells in the Granite Wash/Buffalo Wallow area ended. The total amount spent by Unit towards the Drilling Commitment Amount was $24.6 million. Accordingly, SP Investor will receive 100% of Available Cash distributions related to periods subsequent to December 31, 2021 until the $72.7 million Drilling Commitment Adjustment Amount (as defined in the Agreement) is satisfied.

After April 1, 2023, either Member may initiate a sale process of Superior to a third-party or a liquidation of Superior's assets (Sale Event). In a Sale Event, the Agreement generally requires cumulative distributions to SP Investor in excess of its original $300.0 million investment sufficient to provide SP Investor a 7% internal rate of return on its capital contributions to Superior before any liquidation distribution is made to Unit. As of December 31, 2021, liquidation distributions paid first to SP Investor of $361.7 million would be required for SP Investor to reach its 7% Liquidation IRR Hurdle at which point Unit would then be entitled to receive up to $361.7 million of the remaining liquidation distributions to satisfy Unit's 7% Liquidation IRR Hurdle with any remaining liquidation distributions paid as outlined within the Agreement.

Superior paid cash distributions totaling $24.7 million in April 2021 related to cumulative available cash as of March 31, 2021, $7.7 million in July 2021 related to available cash generated during the three months ended June 30, 2021, $13.9 million in October 2021 related to available cash generated during the three months ended September 30, 2021, and $19.0 million in January 2022 related to available cash generated during the three months ended December 31, 2021. Unit and SP Investor each received 50% of these distributions.

This is all a bit of a mouthful, but I have highlighted the important part, namely: ***this structure is designed to collapse with a full asset sale next April, 2023***. At that time, even if UNTC's 50% share sits marginally behind the residual owed to SP Investor (which I think would be ~$325mm by that date), they would still receive a very significant consideration for their 50% share since Superior is basically an unlevered gathering asset doing ~$60mm of annual EBITDA currently and ~$40mm of annualized FCF based on 1Q numbers:

Superior paid cash distributions of $9.5 million to each of the Members in January 2022 representing Available Cash generated during the three months ended December 31, 2021 and paid $10.5 million of distributions to SP Investor in April 2022 representing Available Cash generated during the three months ended March 31, 2022. The distributions paid to SP Investor in April 2022 reduced the remaining Drilling Commitment Adjustment Amount to $62.2 million.

At a simplistic 10x EV/EBITDA for an asset like this (in line with listed, more levered comps) Superior would be worth $600mm or so and thus after the residual $325mm first payout to SP Investor, UNTC would be looking at something like $275mm in residual value for their junior 50% stake. I will be a bit more conservative than this, though, and simply assume there is some further discount, marking it at $200mm – and thus a further $20 per share. Note that Superior was recently deconsolidated in the accounts, and that a UNTC senior executive at Superior left as well – strongly suggesting to me this asset is also being brushed up for a sales process.

Putting it all together

As constituted, a very rough SoTP thus suggests per **~$118 per share in residual value** to UNTC shareholders, ***good for more than a double on the stock and almost a 4x on the warrants***:

	Value	Notes
Petroleum	850	~35% discount to PV10 at strip?
Drilling	175	mid-point, 2.5x FY1 EBITDA
Superior	200	discount to 50% of $600mm sale px
Net cash	88	1Q'22
Hedge liability	-101	1Q'22
ARO liability	-25	1Q'22
Total value =	**1187**	
Per share	**118**	
Upside vs stock	*113%*	ref $55.5 stock px
Upside vs warrants	*394%*	ref $63.74 strike and $11 warrant px

Warrants vs stock: some of the considerations

As mentioned I have a larger position in the warrants given the deeper upside; long-dated nature of the instrument (defraying the urgency to sell); the theoretical cheapness (Black Scholes tells me these warrants as structured should be >$20 today vs the $11 price); and the similar liquidity profile of both instruments. But there are some additional risks with the warrants. For one, the warrants don't appear to be dividend protected – meaning, if the company were to sell UPC and pay a special $50 or $60 dividend (highly possible), the strike of the warrants (currently $63.74) would NOT be reduced for this payout. Clearly this would leave any residual warrant owners deeply out of pocket – IF they did not convert to stock in time to collect the special dividend.

I am less worried about this outcome, precisely because 1) there would likely be ample time between the announcement of any special dividend and the payout, allowing for warrant conversion to ameliorate this issue; and 2) obviously the stock price would respond positively to this development, driving the warrants up alongside the stock by force of arbitrage; and 3) it is also somewhat likely the company chooses to return capital via a tender or buyback either entirely or partially, reducing the dividend component of any distribution. Obviously this latter outcome is more likely if the stock trades at deeply distressed values (as it currently does) and less likely at higher stock prices. So, I prefer accepting the higher leveraged returns on offer through the warrants, for now, but admit this adds a wrinkle that some won't be comfortable with.

Note that in the event of a full company sale for cash ('Cash Sale' per the warrant agreement), the warrants ARE protected, so the instrument is not totally toothless.

Capital allocation more broadly

It is worth spending a brief moment on capital allocation here as it is one area of strength that I think significantly derisks the thesis. Since emergence, UNTC has already retired >10% of the float, acquiring 1.3mm shares for a $32.6 average price last year (hugely accretive given the move in commodity prices and implied fair value of the ashares today). They didn't execute on the buyback in 1Q – because the sales process for UPC is ongoing and they are no doubt party to privileged information – but I would expect as soon as any process is concluded, if the stock doesn't respond (or if perhaps they only sell a portion of UPC, not all of it), they will simply hoover up more stock as they have been doing in 2021.

Still, I do think an outright sale, first of UPC, then of Drilling and Superior in the next 12-18 months, is by far the most likely outcome. The major shareholder here (Prescott Group) sits on the board; owns a huge, untradeable chunk (converted from debt during the B/K), and is clearly directing traffic. They have no viable exit other than either a piecemeal or total sale, and it certainly appears as if that is the direction of travel, and in the near-term too. But the beauty here is that even if this doesn't eventuate, the equity is cheap enough; the warrants are lengthy enough; and the cycle is robust enough to get us well paid on the back-end too.

Disclosure: long UNTC common and UNTCW

Uncategorized

UNTC

← Reloading the event book (1)

'Markets in turmoil' updates across the board (4) →

28 thoughts on "Reloading the event book (2)"

Christian

MAY 24, 2022 AT 7:27 AM

Thanks — I see Andrew's in this one too.