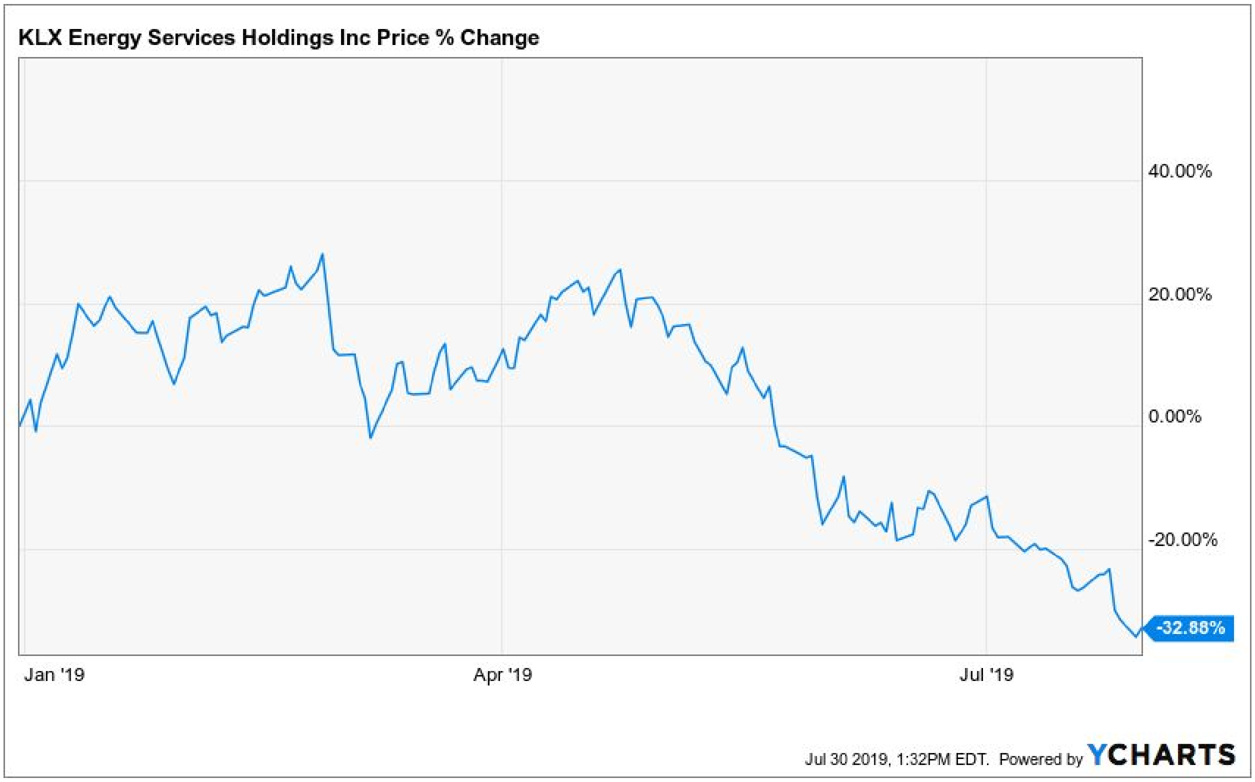
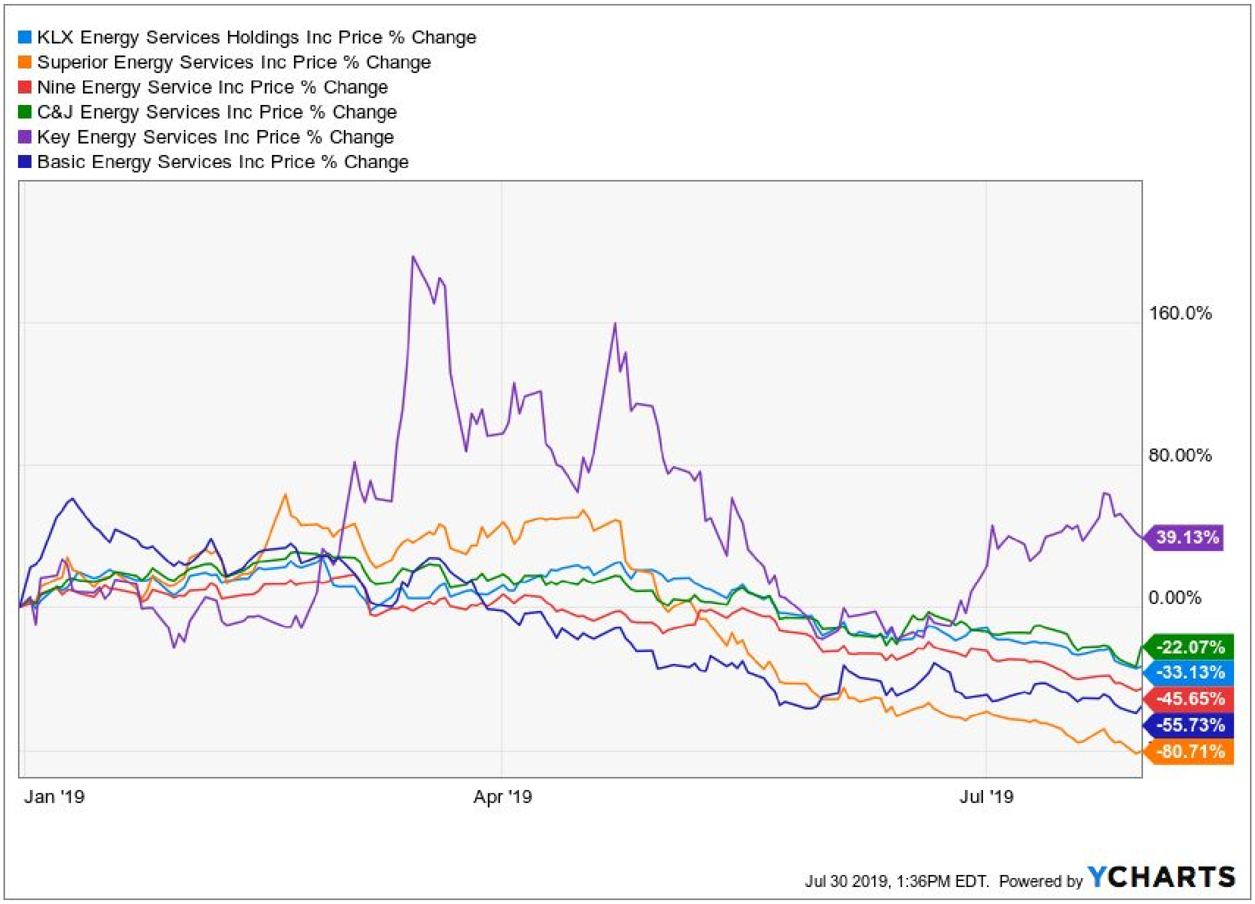
KLXE - July ‘19 Update

Introduction

KLXE, along with the entire energy services sector, has had a very bad 2019. In total, it’s down 33%.



See below for the performance of other small cap energy services peers as compared to KLXE.



I wanted to revisit my KLXE thesis to see if it still stands. I also wanted to evaluate the downside and the upside from here.

Expectations for Q2 2019 Results

I think there is a decent chance that KLXE meets or comes close to meeting Q2 2019 revenue guidance of $180MM (+24% growth) sequentially over Q1 2019 revenue.

In Q1 2019, the company generated $145.8MM in revenue, and that only included one month of the Red Bone and Tecton acquisitions. At the time of the Red Bone and Tecton acquisitions, KLXE raised annual revenue guidance by $50MM. Given there were 10 months left in the fiscal year at the time of the acquisitions, we can estimate that KLXE expects the acquisitions to contribute ~$5.0MM of revenue per month. As such, the contribution to second quarter revenue from these acquisitions should be $15MM. Therefore, the run rate revenue level should increase from $145.8MM to $160.8MM.

To get from $160.8MM to $180MM, KLXE can rely on:
1) A pick up in activity across the board (Management noted April revenue was 24% higher than February revenue).

2) The planned roll out of large diameter coiled tubing units in the Mid Con and Rockies. This is important because it pulls through demand for other ancillary services.

Also, Gary Roberts' insider purchases in June (at higher prices) suggest that the quarter was progressing relatively well.

Further, Halliburton said on its most recent quarterly call, "In North America, revenue in the second quarter of 2019 was $3.3 billion, a 2% increase. Improvements were primarily driven by higher stimulation artificial lift and **wireline activity** in North America." The fact that wireline activity was strong in the quarter (an area that KLXE had mentioned as weak due to pricing issues) is a positive.

Finally, KLXE currently has 64 job openings. This is after they hired 70 personnel to run the large diameter coiled tubing units. This hiring implies that KLXE is still in growth mode.

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Will KLXE Cut Annual Guidance?

I think that it's likely that annual guidance is reduced.

Currently management has guided to revenue of $800MM (+65% growth) and EBITDA of $200MM for Fiscal 2020 (year ends in January 2020).

In 2018, KLXE generated $495.3MM of revenue.

Motley (a 2018 acquisition) is focused on coiled tubing service.

In the first half of 2018, Motley generated $58.6MM or revenue. In Q3 2019, it generated $34.1MM. KLXE didn't break out Motley revenue in Q3 2018, but management noted that it was down significantly. Assuming a 20% decline in coiled tubing revenue, we can estimate Motley revenue of $27.3MM in Q4 2019.

Excluding Motley's Q4 2018 contribution of $27.3MM, KLXE generated $468MM of revenue. Let's assume for the moment that that revenue stays flat in 2019.

Now, we can add Motley's revenue contribution of $120MM (same as 2018).

Finally we can add $50MM from RedBone and Tecton (per management's guidance)

Add it all up and we get $638MM of revenue. To get to annual guidance of $800MM, KLXE will need 25% growth from core KLXE and Motley.

What will drive the growth?

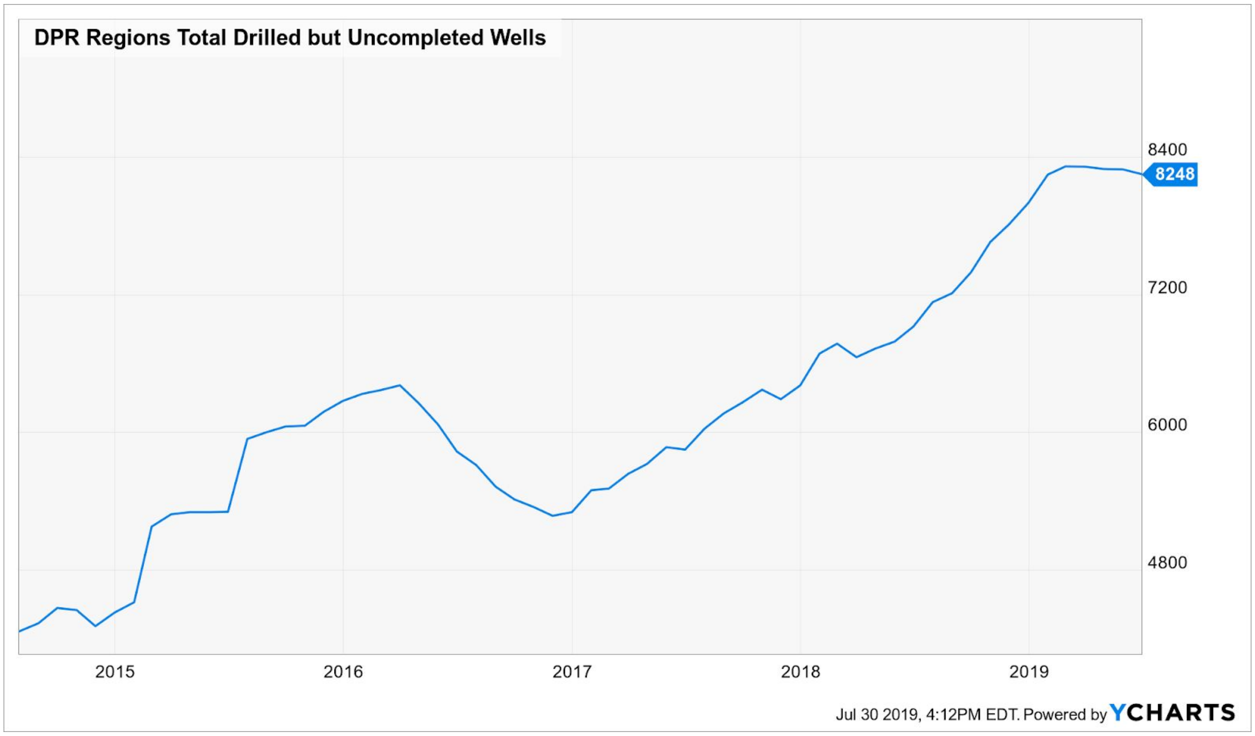
#1 Rig Counts

If we see rig counts growing again, that will help. However, so far we've seen the number of rigs in the United States continue to fall.

#2 Drilled But Uncompleted Wells (DUCs)

~50% of KLXE's revenue comes from well completions, so once the number of DUCs or drilled but uncompleted wells begins to decline rapidly, completion revenue should ramp up significantly for KLXE.

DUCs in the US started to decline in March 2019 as shown in the chart below.



However, DUCs in the Permian Basin continue to rise and represent 49% of total DUCs. Until Permian DUCs begin to decline, we won't see a dramatic fall off in DUCs. The main reason DUCs are elevated in the Permian is because there isn't enough pipeline capacity to get the oil out of the fields.

However the bottleneck problem is in the process of being solved.

KLXE management noted in its last earnings call that it expects the Permian takeaway issue to be largely resolved by the end of the second fiscal quarter (July 2019).

Specifically, the **EPIC** crude oil pipeline recently began operations. It has the ability to transport 400,000 barrels-per-day from the Permian Basin to Corpus Christi, Texas. Crude flows will ramp up each month as the company adds storage facilities in the Permian and also near Corpus Christi.

The **Cactus II** pipeline is scheduled for initial service by the end of the third quarter. This pipeline will have the capacity to transport 670,000 barrels-per-day from the Permian Basin to Corpus Christi, Texas.

The **Grey Oak** pipeline will be completed by the end of 2019. It will have the capacity to transport 900,000 barrels-per-day from the Permian to Corpus Christi, Texas.

One issue to be aware of is that, currently there may not be enough storage infrastructure in Corpus Christi to accommodate the increased flow of crude, which may result in another temporary bottleneck. Nonetheless, ultimately it will be resolved.

The resolution of the Permian takeaway issues should be a major boost to KLXE's completion business. However, I'm concerned that it will not materialize meaningfully enough this year.Nonetheless, it should be a tailwind in 2020.

#3 Oil and Gas Capex Plans

In March 2019, the Oil & Gas Journal projected that United States capex would increase by 2% in 2019. However, Schlumberger projected on its recent earnings call in July that oil and gas operators were reducing capex in 2019 by 10%.

Upstream oil and gas capex is the life blood of the energy services industry, so this downward revision is a negative for KLXE.

There have been many articles covering covering how oil and gas companies are focused on capital discipline and generating positive free cash flow. This new focus is healthy for the industry long term, but will pressure energy service firms in the near term. Nonetheless, I think KLXE is well positioned among energy services company as it has less debt and focuses on higher margin services. Ultimately, I believe this will enable KLXE to continue to take share.

Given the falling number of rigs, the rising number of drilled but uncompleted wells in the Permian, and falling oil and gas capex plans, I would be surprised if KLXE is able to achieve 25% revenue growth (core KLXE and Motley) in 2019.

However, I'm bullish on KLXE long term. In 2020, assuming stable oil prices, rigs will begin to come back on the market and more importantly, the number of drilled but uncompleted wells will decline substantially providing a major tailwind to KLXE's completions business.

What is the Downside from Here?

It's hard to quantify the downside, unfortunately.

Why?

Because small cap energy services companies (SPN, BAS, KEG) are trading at all time lows, below where they traded in other cyclical downturns (2009 and 2016).

Even large energy services companies are trading at or near 10 year lows. Schlumberger and Baker Hughes are trading below prior lows in 2009 and 2016. Halliburton is below where it traded in 2016, and only ~16% higher than it traded in the Great Financial Crisis in 2009.

KLXE’s price can definitely go lower and we don’t really have an anchor as to how low it could go.

However, I’m very confident that KLXE isn’t at risk of bankruptcy.

Let’s explore a very negative scenario.

In calendar year 2016, the last down cycle in the energy industry, KLXE energy revenue declined by 60% from the prior year and EBITDA and operating earnings went negative.

In calendar year 2016, the energy division generated a pre-tax loss of $91.2MM! he cash loss would be significantly lower after adding back non cash charges like depreciation and amortization. In addition, KLXE spent a significant amount of time and energy reducing costs, consolidating facilities, and rightsizing headcount. As a result, it was able to reduce cash burn to $10.6MM by the 4th quarter of 2016 ($42.4MM on an annualized basis).

This is a very draconian scenario, as oil went below $30/bbl in 2016. In this scenario, KLXE’s cash burn rate would be $45MM (rounding up).

Currently, KLXE has $110MM of cash on its balance sheet and a $100MM revolver that it could use. Thus, KLXE would have significant liquidity to wait out the downturn.

KLXE does have debt on its balance sheet of $242.2MM. However, the debt does not mature until 2025, and so there will not be a situation where energy markets tank and KLXE has to refinance its debt.

What is the Upside From Here?

In a more optimistic scenario in which sentiment and the business environment has improved in U.S. energy markets, it would be reasonable for KLXE to be valued at 8.0x EBITDA. Let’s assume a few years down the road, the energy environment improves and KLXE is able to generate $200MM of EBITDA (not a stretch given that $200MM in EBITDA is this year’s guidance). In that scenario, a fair enterprise value (I assume cash and debt stay at current levels), market cap and share price would be $1.6BN, $1.5BN, $63.

This would represent ~280% upside from current levels. This scenario may seem hard to believe, but remember, this management team owns a significant portion of the business and has historically sold businesses that they’ve run at very attractive multiples (BEAV and KLXI were sold at 12.4x and 14.3x multiples).

Further, two larger energy services companies, Apergy (APY) and Schlumberger (SLB), trade at 11.0x EBITDA and 10.3x EBITDA, respectively. Either company could acquire KLXE for 8.0x TODAY, and the deal would immediately be accretive.

When will KLXE generate actual free cash flow?

In my valuation for KLXE, I've generally based my valuation around EV/EBITDA because it normalizes for capital structure and taxes.

But of course, the energy services business is capital intensive so it's important to look at underlying earnings and cash flow.

First, let's review 2018 earnings. KLXE reported adjusted EPS of $2.81. However, part of that adjustment is for non-cash compensation of $12.8MM. That is a real expense so I add it back. The other costs that were removed were amortization (a true one time cost) and $30.6MM of one-time costs associated with the spin-off and the issuance of bonds. Adding back non-cash compensation results in KLXE generating $2.18 in diluted earnings in 2018. As such, the stock is trading at 7.2x 2018 earnings. This seems very cheap.

In 2018, the company generated $62MM of operating cash flow and spent $84MM of capex. As a result, it generated -$22MM of free cash flow. This investment is part of the company's strategic plan to expand its footprint in each geographic segment.

This strategic plan has continued into 2019. Management has guided that it expects to spend $100MM in 2019 to continue to broaden its footprint in all regions including the roll out of its large diameter coiled tubing business in the Rockies and Mid-Con.

However, the heavy investment period of KLXE's strategic plan will conclude in the 4th quarter. In 2020 and beyond, the company expects to generate strong free cash flow.

In past years, before this heavy investment, KLXE has spent far less on capex. For instance, in calendar year 2017, the company spent $48.8MM on capex. In calendar year 2016, the company spent $29.0MM. The company has guided that the business requires $25MM to $30MM of maintenance capex and that all additional spend is growth capex.

I'm assuming that capex will decrease to ~$41MM in 2020, in line with annual depreciation.

If that is the case, net income should approximate free cash flow in 2020 and beyond. I forecast that KLXE will generate $51MM of net income in 2019. Assuming no growth in 2020, net income and free cash flow should be ~$51MM. If that projection is right, KLXE is trading at 7.1x 2020 free cash flow.

In summary, KLXE is on track to generate considerable free cash flow, assuming the energy market is stable.

Conclusion

While the volatility of KLXE shares is painful, I recommend investors hold onto their shares or buy more. I see a favorable risk reward outlook for KLXE. While the company could see additional downside given volatility in the energy markets, I do not see the risk of bankruptcy. In a more favorable energy environment, the stock could appreciate ~300%. As such, I see a favorable asymmetric opportunity.