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COMPANY BRIEF

# U.S. GAS COMPRESSION RENTAL INDUSTRY

*WITH A FOCUS ON*

## NATURAL GAS SERVICES GROUP, INC. (NGS)

JUNE 28, 2017

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# HEDGEYE COMPANY BRIEF: US GAS COMPRESSION RENTAL

1

## INDUSTRY STRUCTURE & DYNAMICS ARE WEAK

The US gas compression rental industry is in very tough shape, and it's more than just a cyclical downturn.

2

## NGS IS A WELL-RUN OPERATION, BUT ITS MARKET IS CHALLENGED

NGS is, by far, the best of the compression rental pure plays, but it, too, has its issues. We'd be interested in adding NGS to our Best Ideas list closer to tangible book value of ~$17/share. We think that the stock is fairly-priced today at ~$25.

3

## STAY AWAY FROM ARCHROCK, USAC & CCLP

In our view, these are bad businesses with worse balance sheets. We have no interest in them on the long side here, and would consider them as shorts should sentiment improve and valuations rise.

# KEY TAKEAWAYS

## UNATTRACTIVE INDUSTRY, BUT NGS IS A BRIGHT SPOT

- The publicly-traded US compression companies are Archrock (APLP, AROC), USA Compression Partners (USAC), CSI Compressco LP (CCLP), Natural Gas Services Group, Inc. (NGS), and CDM Resource Management LLC (a subsidiary of ETP).
- **<u>There's not much to like about the US compression services industry:</u>** it's highly competitive, fragmented, capital-intensive, cyclical, and commodity price sensitive. As evidence, average, unlevered ROICs are currently in the low single digits, and were only ~8% at the prior cycle peak in 2014.
- **<u>The MLP structure has wreaked havoc on the compression rental industry</u>**. Maybe it was a good idea on paper, but it's been a disaster in reality. The compression rental business is highly-cyclical and sensitive to commodity prices (particularly at lower HP levels), not well-suited for high debt leverage and a high, fixed distribution payout. Further, compression MLPs have put significant pricing pressure on the entire industry due to their willingness to rent equipment at a rate that achieves a targeted return *based on EBITDA rather than EBIT or net income*. APLP, USAC, and CCLP are all +5x levered, and APLP and CCLP have already cut distributions.
- The industry has under-appreciated leverage to US unconventional *oil* plays (Permian) via wellhead gas lift.
- **<u>NGS is the lone bright spot in the sector</u>**. We like NGS relative to the peer group. The Company has several unique and attractive characteristics:
    1. "Southwest Airlines" business model – builds all of its own compressors to same specs which allows for more efficient and lower-cost maintenance, better run-time stats, and higher rental rates. NGS typically charges a 5-10% premium compared to its competitors.
    2. Conservative accounting and financial reporting. *Expenses* 100% of maintenance and refurbishment costs on existing compressors. All capital expenditures are spent on building *new* equipment. EBITDA is representative of sustainable cash flow.
    3. **Net cash position of $74MM (~$6/share) and no debt. No dividend.**
    4. Strong cash flow generation in the down-cycle: NGS generated *real* free cash flow of $32MM ($2.50/sh) in 2016 and $10MM ($0.78/sh) in 1Q17.
    5. Mired in the down-cycle, NGS's fleet is only ~50% utilized. We view NGS an attractive call option on higher commodity prices / a US OFS recovery.
    6. **At the current price of ~$25/share, we think NGS is fairly-priced We would be more interested < $20/share. Tangible book value of $17/share should lend downside support.**
    7. We are impressed with NGS's CEO, Steve Taylor. No promotional or misleading management tactics.
- **<u>We would not touch APLP, USAC, or CCLP on the long side</u>.** In our view, these are bad businesses with way too much debt. Our field work came back especially negative on Archrock. Archrock is the largest player in the US compression industry, but has the worst reputation for customer service.

Sources: Company Filings & Presentations

# COMPANY COMP SHEET

**Public Compression Industry Comp Sheet**

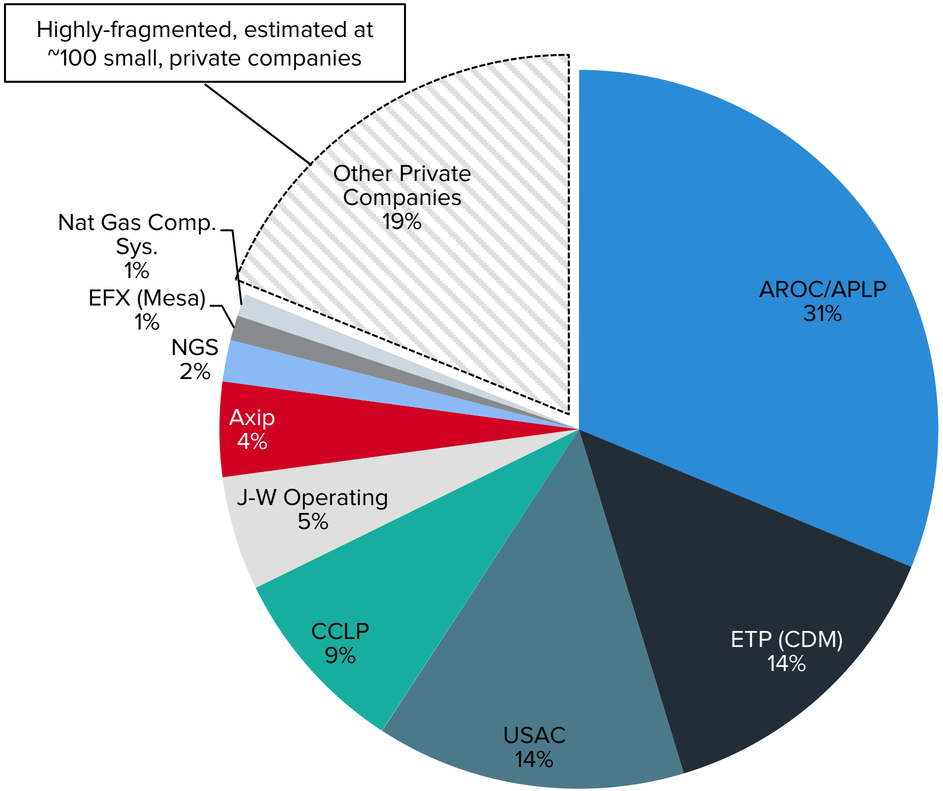
| | NGS | CCLP | USAC | APLP |
|---|---|---|---|---|
| **Capital Structure** | | | | |
| Price | $ 24.50 | $ 4.21 | $ 15.96 | $ 14.04 |
| Shares or Units O/S (MM) | 13 | 34 | 61 | 66 |
| **Market Cap** | **$ 314** | **$ 142** | **$ 976** | **$ 922** |
| Net Debt + Pref Equity | $ (74) | $ 592 | $ 715 | $ 1,339 |
| **Enterprise Value** | **$ 240** | **$ 734** | **$ 1,691** | **$ 2,261** |
| **Operating Stats (1Q17A)** | | | | |
| Total Compression Units | 2,531 | 5,852 | 3,337 | 6,166 |
| Total Horsepower (000) | 362 | 1,109 | 1,739 | 3,267 |
| Operating Horsepower (000) | 181 | 853 | 1,428 | 2,826 |
| Horsepower Utilization | 50% | 77% | 82% | 87% |
| Avg. Horsepower per Unit | 143 | 189 | 521 | 530 |
| **Income Statement (2016A)** | | | | |
| Revenues | $ 72 | $ 311 | $ 266 | $ 562 |
| Gross Profit | $ 40 | $ 120 | $ 178 | $ 353 |
| *Gross Margin* | *56%* | *39%* | *67%* | *63%* |
| EBITDA | $ 31 | $ 84 | $ 133 | $ 273 |
| *EBITDA Margin* | *43%* | *27%* | *50%* | *49%* |
| GP Distribution | $ - | $ (1) | $ (3) | $ (6) |
| EBITDA after GP | $ 31 | $ 83 | $ 130 | $ 267 |
| EBIT after GP | $ 9 | $ 11 | $ 38 | $ 113 |
| *EBIT Margin* | *13%* | *3%* | *14%* | *20%* |
| EPS to Common | $0.55 | -$1.02 | $0.27 | $0.55 |

| | NGS | CCLP | USAC | APLP |
|---|---|---|---|---|
| **Cash Flow Metrics (2016A)** | | | | |
| FCF | $ 26 | $ 44 | $ 73 | $ 135 |
| *FCF Margin* | *37%* | *14%* | *27%* | *24%* |
| Dividend / Net Income | NA | -147% | 877% | 236% |
| Dividend / FCF | NA | 113% | 200% | 63% |
| **Balance Sheet** | | | | |
| Net Debt + Pref Equity (1Q17A) | $ (74) | $ 592 | $ 715 | $ 1,339 |
| Net Debt (1Q17A) / EBITDA (2016A) | (2.4x) | 7.1x | 5.5x | 5.0x |
| **Returns (2016A)** | | | | |
| Pre-tax ROIC | 4.0% | 1.6% | 3.2% | 4.1% |
| EBITDA Build Multiple | 11.0x | 11.3x | 12.4x | 10.1x |
| Net PP&E/Sales | 2.5x | 2.1x | 4.8x | 3.1x |
| **Valuation Multiples** | | | | |
| Current EV / Sales (2016A) | 3.4x | 2.4x | 6.4x | 4.0x |
| Current EV / EBITDA (2016A) | 7.8x | 8.9x | 13.0x | 8.5x |
| Current EV / EBIT (2016A) | 26.8x | 68.3x | 44.4x | 20.0x |
| Current EV / Unlevered FCF (2016A) | 6.8x | 7.8x | 9.3x | 6.9x |
| P / E (2016A) | 44.6x | (4.1x) | 58.3x | 25.4x |
| Dividend Yield (1Q17A) | 0.0% | 17.8% | 13.2% | 8.1% |
| Price / TBV (1Q17A) | 1.4x | 1.7x | 1.7x | 2.2x |
| Current EV / Total HP (1Q17A) | $ 662 | $ 662 | $ 972 | $ 692 |

Sources: Company Filings; FactSet Data

# COMPRESSION RENTAL INDUSTRY STRUCTURE

## Est. Market Share by Total Horsepower




**25 - 400 HP Compressors**

- Market Leaders: APLP, CCLP, NGS, USAC
- Typical applications: Wellhead Compression, Gas Lift, & Vapor Recovery
- Customers: E&Ps
- Contract Length: 1 month – 12 months
- Demobilization Costs**:** $500-$10k

**400 - 1000 HP Compressors**

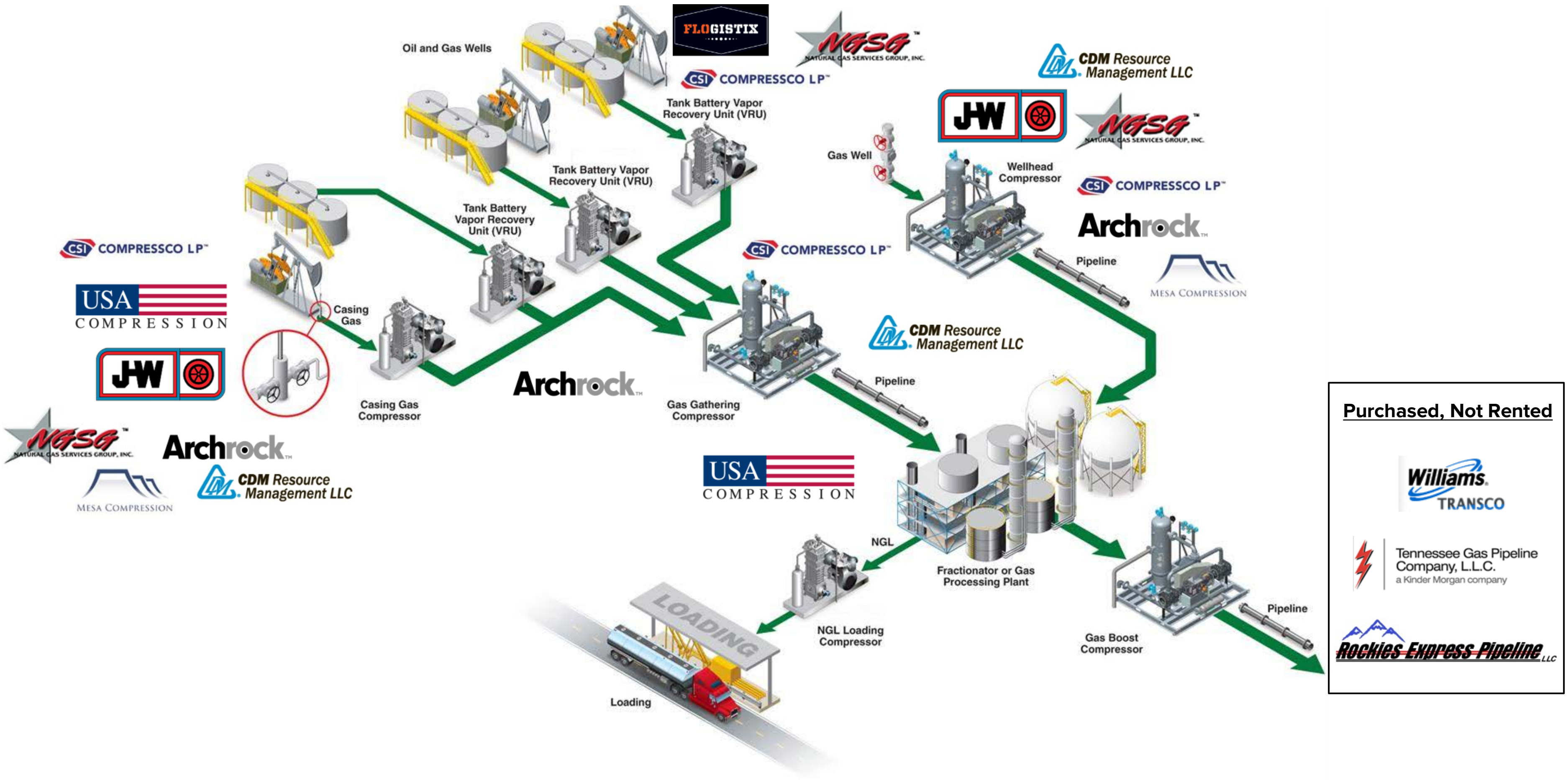
- Market Leaders: APLP, ETP, USAC, CCLP
- Typical applications: Wellhead Compression, Gas Lift, & Gathering Systems
- Customers: E&Ps, Midstream G&Ps
- Contract Length: 1 month – 2 years
- Demobilization Costs: ~$25k

**1000+ HP Compressors**

- Market Leaders: APLP, USAC, ETP, CCLP
- Typical applications: Gathering Systems, Centralized Compression
- Customers: E&PS, Midstream G&Ps
- Contract Length: 2 years – 5 years
- Demobilization Costs: $50k+

Sources: Company Filings & Presentations; Hedgeye Estimates

# GAS COMPRESSION IN THE MIDSTREAM SUPPLY CHAIN



# OUR “FIELD WORK”

## KEY TAKEAWAYS FROM OUR DISCUSSIONS WITH INDUSTRY PARTICIPANTS

- “Reliability is key to profitability.”
- “At the lower HP levels, this business is all about customer service and maintenance.”
- “Smaller, private players are taking market share from the MLPs as they cut costs and reduce service levels.”
- “The E&P typically bears the shipping cost of the compressor unit, and that is a significant factor to consider.”
- “The Permian is a big gas compression market, but it’s super competitive. There are at least 5 or 6 new, privately-backed compression companies and they are all aggressive on price.”
- “Beware of public company utilization statistics. We think most of those companies jack around with those numbers and present a higher utilization number to the public than what is really the case.”
- “Public companies have been selling the idea that equipment is maintained and ready to go into service. That’s not the case”
- “This industry is not acquisition fertile, merging different fleets and maintenance staffs doesn’t work. Both of the big industry mergers [Exterran/Hanover and CSI/Compressco] were disasters.”
- “Among the larger compression companies, JW Operating [private] and USA Compression have the best service reputations. Archrock has never been known as a quality service company.”
- “Archrock is the Walmart of compression, they try to be everything to everyone.”
- “We’re still seeing bad pricing. We need stable oil prices near $60/bbl, to really start seeing improved pricing.”
- “There is no price discipline in this industry, particularly from big MLPs.”
- “We’ve seen prices steadily increasing since the start of 2017. Rental rates are probably up 25% from the bottom.”
- “The market for large HP units [+700 HP] is tight, there is a shortage of engines. But there’s a lot of availability at the 145 HP range.”
- “6 months ago the 145-200 HP compressor unit was in high demand in the Permian. We’ve had 30 units returned in 6 months as customers switch to units 600HP+.”
- “Even though oil prices have recently dropped, projects signed over the last six months are still going forward. We may see another slow down, but the next six months should be pretty good.”
- “The last thing this industry needs is a double dip. Many compression and oilfield services companies are still on their knees, another downturn would be extremely painful.”

# KEY INDUSTRY TRENDS

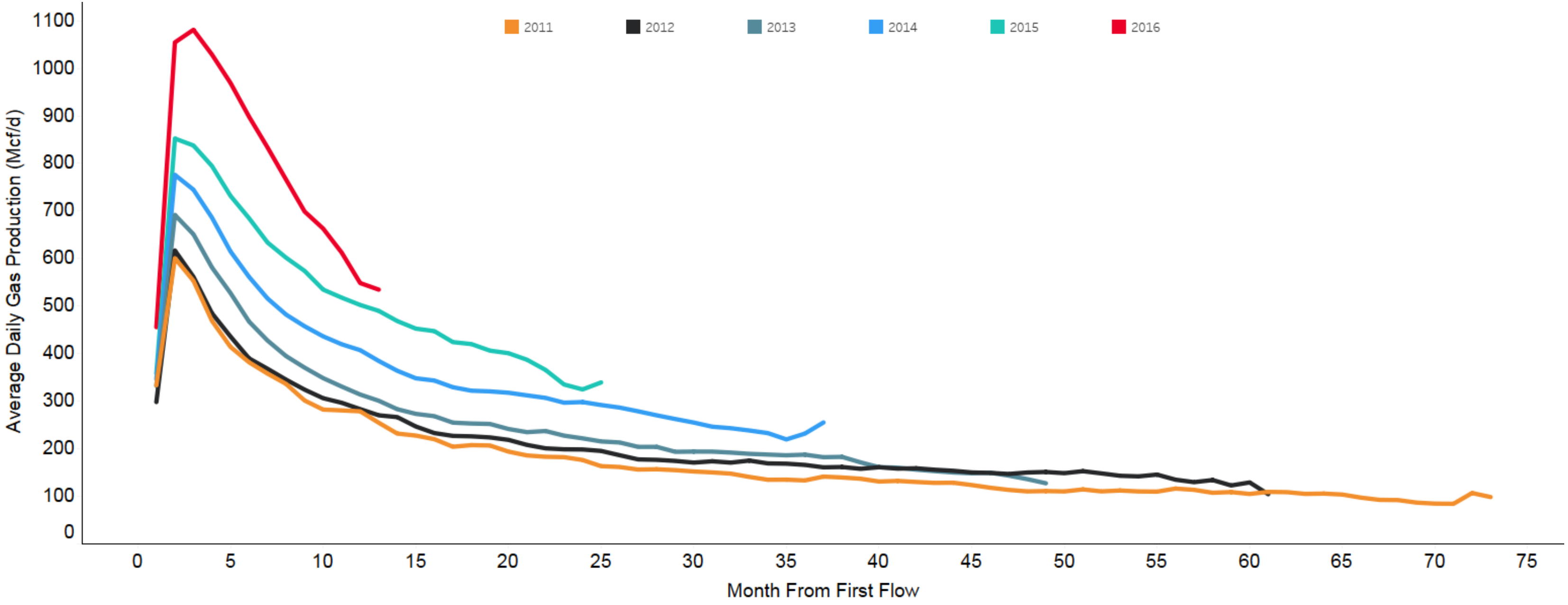
| US Oil & Gas Trends | Impact on Compression Rental Industry | Winners | Losers |
|---|---|---|---|
| Low oil prices | Reduced economic incentive for E&Ps to use gas lift | | NGS, CCLP |
| Activity shift to liquids-rich shale (Permian) | Increased demand for gas lift and VRUs | All | |
| "Associated gas" (Permian) taking market share from pure gas wells | Increased demand for gas lift and VRUs | All | |
| Increased production per well | Increased demand for high HP units, pushed out demand for lower HP units | USAC, APLP | NGS, CCLP |
| Pad drilling and centralized gathering and gas lift systems | Increased demand for high HP units, reduced demand for lower HP units | USAC, APLP | NGS, CCLP |

## CURRENT TRENDS BENEFIT THE HIGHER HP PROVIDERS

The US E&P industry has shifted to oil shale plays (Permian), bigger wells, and more efficient operations (pad drilling, centralized gathering), most of which necessitates larger compressors, +600 HP. We expect the market for lower HP compression to remain soft and be the last to recover.

# INDUSTRY TRENDS: BIGGER WELLS NEED HIGHER HP

## AVERAGE PERMIAN GAS WELL TYPE CURVE BY YEAR COMPLETED

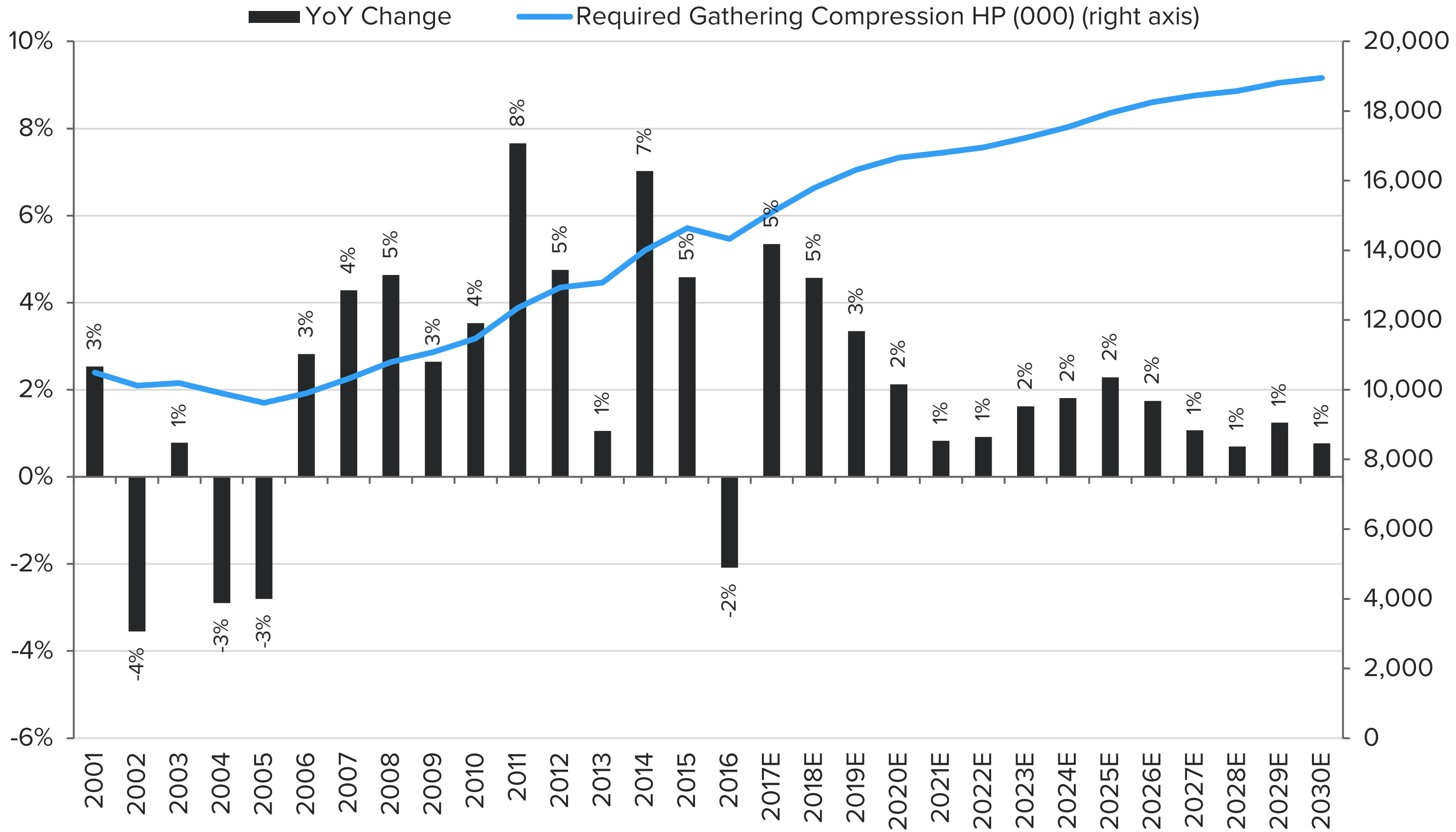



The Permian is a growth opportunity for the compression rental industry. But the trend of bigger wells – as clearly demonstrated in the above chart – as well as pad drilling, necessitates higher HP units for gas lift and field compression. The majority of US shale oil wells go on gas lift in the first 6 months of production, but now starting at higher HP levels. The market opportunity for smaller HP units (sub 200 HP) has been pushed out by 1 – 2 years. Today, the compression rental market is tightest in the 600 – 800 HP range.

Sources: Raw Data from State Regulatory Websites, Shale Profile

# INDUSTRY TRENDS: NATURAL GAS GATHERING GROWTH

## NATURAL GAS COMPRESSION IN THE FIELD




US natural gas production growth is a tailwind for the compression industry, particularly in the mid and higher HP categories.

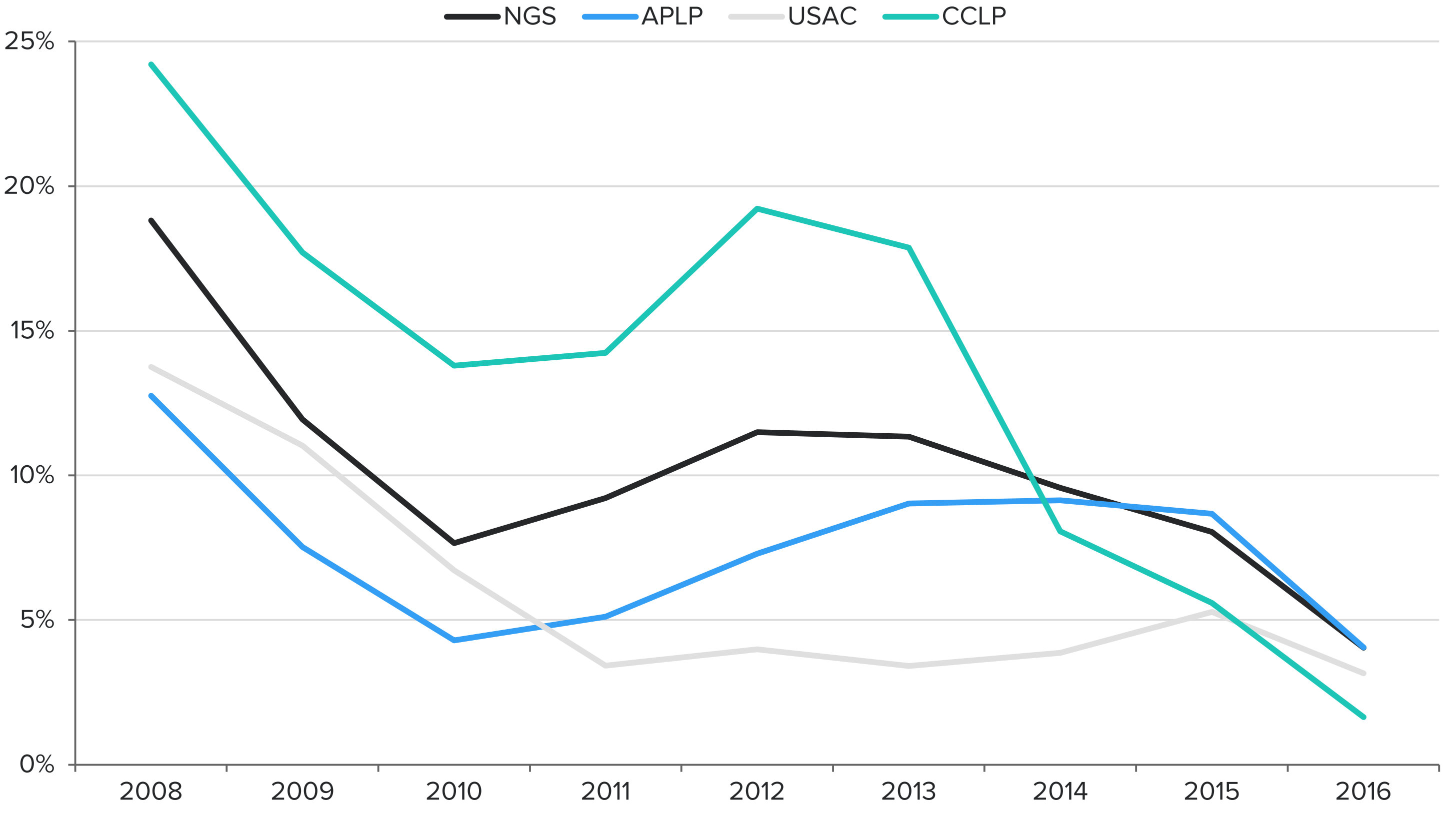
USAC, APLP, CCLP, and compressor OEMs stand to benefit most.

*Memo: Graph assumes 1 MMcf/d requires 200 HP of compression, per CCLP estimates.*

Sources: EIA; CCLP Investor Presentations

# ANOTHER UNECONOMIC ENERGY SECTOR?

## RETURNS ON INVESTED CAPITAL (PRE-TAX AND PRE-GP)




Pre 2010, this was a solid industry with companies achieving ROICs in the range of ~10 – 20%.

Even in 2014, a strong year for the US OFS and midstream sectors, the average ROIC for the compression industry was 8%.

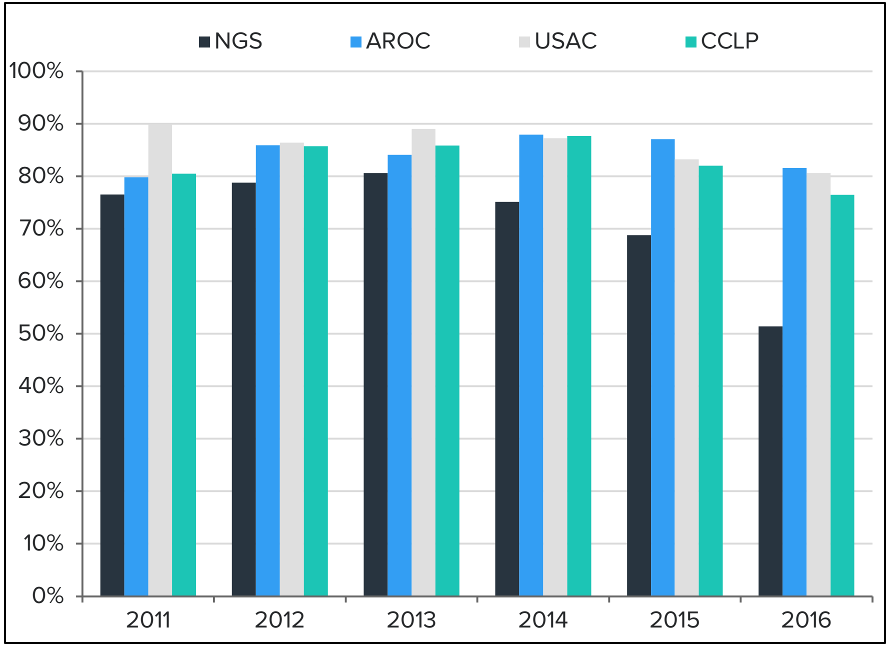
A number of factors have lead to weak ROICs in recent years:

- Cheap and abundant capital available to the US energy industry…
- …That lead to aggressive HP supply growth;
- The movement of HP into MLP structures;
- The rise of unconventional, highly-pressured natural gas plays;
- The 2015-2016 oil price-driven downturn.

Source: Company Filings

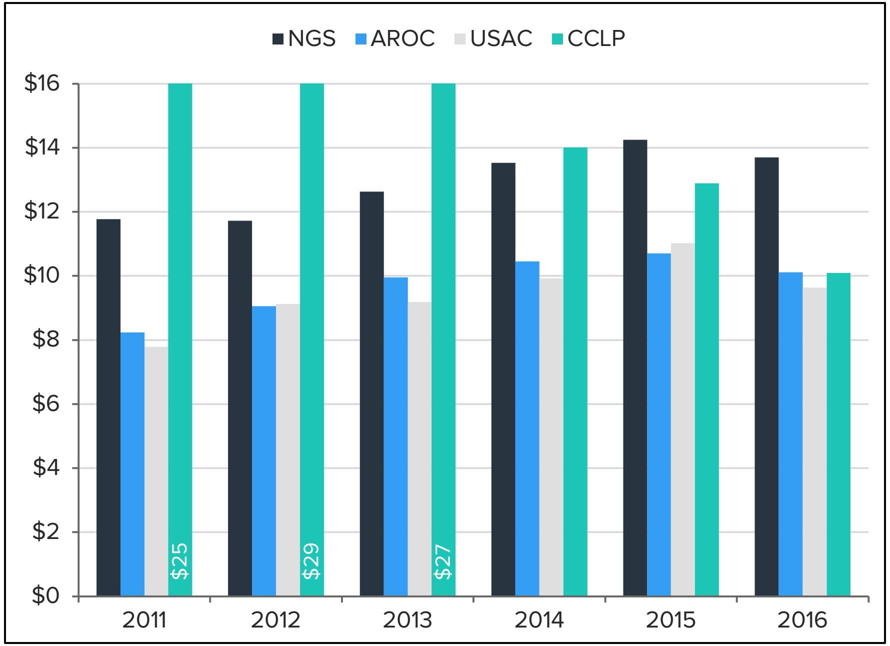
# INDUSTRY OPERATING METRICS

## UTILIZATION RATES




NGS's utilization has been hit hardest in the downturn due to its position in the lower HP market. USAC and APLP's utilization has held up better due to stickier, higher HP assets. Companies define "utilization" differently, and these may not be apples-to-apples metrics.

## GROSS PROFIT PER MONTH PER HP




Smaller HP units rent for a higher rate than larger units. Industry-wide pricing has been under pressure since 2014, but is likely bottoming in 1H17. Our field work suggests that NGS typically charges a 5 – 10% premium versus its peers, and the Company has been unwilling to sacrifice price for utilization.

# NGS VALUATION

## FAIRLY-PRICED ~$25, WE'D BE INTERESTED CLOSER TO TBV OF $17

**Natural Gas Services Group, Inc. (NGS) - DCF Valuation** *WACC Assumption: 9.0%*

| Year | Unlevered FCF | Discount Factor | PV of U-FCF |
|---|---|---|---|
| 2017 | $ 25 | 0.917 | $ 23 |
| 2018 | $ 12 | 0.842 | $ 10 |
| 2019 | $ 9 | 0.772 | $ 7 |
| 2020 | $ 13 | 0.708 | $ 9 |
| 2021 | $ 19 | 0.650 | $ 12 |
| 2022 | $ 21 | 0.596 | $ 13 |
| 2023 | $ 22 | 0.547 | $ 12 |
| 2024 | $ 22 | 0.502 | $ 11 |
| 2025 | $ 23 | 0.460 | $ 10 |
| 2026 | $ 23 | 0.422 | $ 10 |
| 2027 | $ 24 | 0.388 | $ 9 |
| 2028 | $ 24 | 0.356 | $ 9 |
| 2029 | $ 25 | 0.326 | $ 8 |
| 2030 | $ 25 | 0.299 | $ 7 |
| 2031 | $ 26 | 0.275 | $ 7 |
| Terminal | $ 348 | 0.275 | $ 95 |
| **Operating Value** | | | **$ 253** |
| *Mid -Year Adjustment Factor* | | | *1.000* |
| **Operating Value (Adjusted)** | | | **$ 253** |

| | |
|---|---|
| Operating Value | $ 253 |
| Excess Cash | $ 60 |
| Financial Investments | $ - |
| Excess Pension Assets | $ - |
| **Enterprise Value** | **$ 313** |
| Debt | $ (0) |
| Capitalized Operating Leases | $ - |
| Retirement Related Liability | $ - |
| Preferred Stock | $ - |
| Minority Interest | $ - |
| Restructuring Provision | $ - |
| Stock Options | $ - |
| **Equity Value** | **$ 313** |
| Shares O/S (MM) | 12.8 |
| **Value per Share** | **24.00** |
| Market Price | 24.50 |
| *Upside (Downside) to FV* | *-2.0%* |

**Recent Compression M&A Activity**

| Buyer | Seller | Date | Purchase Price ($MM) | Fleet HP (000) | # of Units | Avg. HP per Unit | $ per HP |
|---|---|---|---|---|---|---|---|
| USA Compression | S&R Compression LLC | Aug 2013 | $ 179 | 138 | 983 | 140 | $ 1,293 |
| Access Midstream | Chesapeake Energy | Mar 2014 | $ 159 | 200 | 103 | 1,942 | $ 795 |
| Archrock Partners | Chesapeake Energy | Apr 2014 | $ 353 | 444 | 337 | 1,318 | $ 795 |
| CSI Compressco | Compressor Systems, Inc. | Jul 2014 | $ 825 | 858 | 2,200 | 390 | $ 962 |
| Mesa Compression | Chesapeake Energy | Aug 2014 | $ 63 | 76 | 466 | 163 | $ 832 |
| Archrock Partners | Chesapeake Energy | Aug 2014 | $ 130 | 110 | 162 | 679 | $ 1,183 |
| Archrock Partners | Unknown | Mar 2016 | $ 19 | 23 | 19 | 1,211 | $ 817 |
| Enerflex Ltd. | Mesa Compression | Jun 2017 | $ 106 | 112 | 689 | 163 | $ 946 |
| **Average** | | | | | | | **$ 953** |

At a 9% WACC, we value NGS at $24/share.

We would note that NGS is currently trading at $660/HP on an EV basis, a ~30% discount to replacement cost (~$1,000/HP) and recent M&A multiples (~$950/HP). Though with only 50% utilization, the discount may be warranted.

Tangible book value is $17/share and should provide downside support.

In a recovery, we estimate that NGS could generate ~$45MM of EBITDA, which would put the Company at ~5x EV/EBITDA with no debt. In an optimistic / full recovery scenario, NGS could be worth $30 - $40/sh.

Source: Company Filings

# THANK YOU