

Mr. Bert

Long/short equity, value, special situations

(421 followers)

Summary

Select Energy Services, Inc. (WDDR) is a unique growth company with no other direct comparable. If you are invested in fracking or Permian-related stocks, this is a must-read article.

Even though Select's customers are in the commodity business, Select itself is not. This is a franchise company with a wide moat and it boasts a vastly superior business model.

Select is growing rapidly and has a pristine balance sheet. Demand for its services is rapidly growing and **its platform is now virtually impossible to replicate.**

Yet, the stock is selling at just 13.3x 2018 earnings and 8.0x 2019 earnings. I expect the stock to earn significantly more than current estimates.

Finally, I also offer an elegant and simple idea by which the company can repurchase up to 13% of its stock at today's prices, with no incremental capital requirements.

Select Energy Services (WTTR) is a rapidly growing, high quality franchise company that provides water sourcing and water management services to companies engaged in the shale drilling and hydraulic fracturing ("fracking") business. Because both its customers, and its customers' customers, offer a commodity product or service, **WTTR is also typically viewed as doing so as well.** But that is not true. It is a franchise company with a highly protected competitive position. If you want to participate in the growth of U.S. oil production, while limiting your commodity exposure, this is the way to do so.

Investors who own either pressure pumping or frac sand companies should read this article carefully. The demand drivers for WTTR's business are the same, but the supply drivers are entirely different. WTTR is a high-quality company that offers far greater upside at a fraction of the commodity exposure.

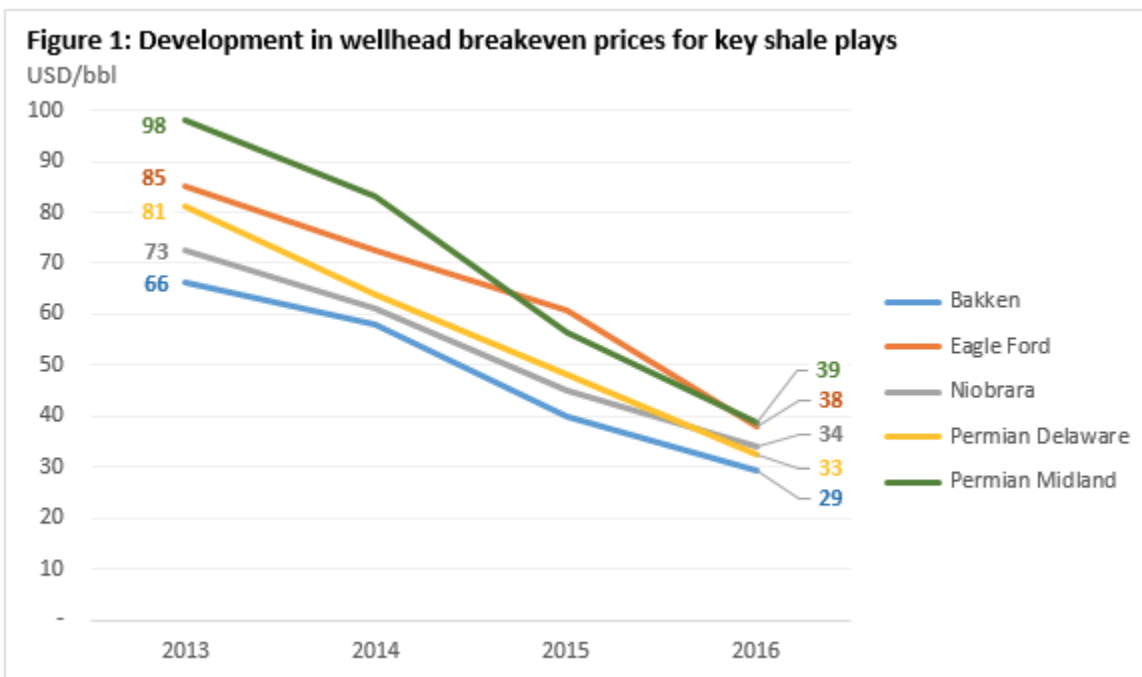
I believe investors in WTTR can at least triple their money from today's prices over the next 12 to 18 months. The shares are deeply undervalued and can more than double just to get to my fair value range of \$26 to \$33. I also expect significant revenue, cash flow and earnings growth that will further increase the intrinsic value of the company.

INVESTMENT THESIS

Over the past several years, the United States has entirely reversed a forty-year decline in crude oil production, regained its energy independence and reemerged as a global energy superpower, second only to Saudi Arabia, in annual output. The economic and geopolitical significance of this cannot be understated.

The reason for this astonishing resurgence is the energy industry's development and refinement of modern fracking techniques, which enable the extraction of crude oil from shale on a highly economic basis. **Over the last five years, the necessary oil breakeven price to do so has declined from an average of \$66-98/barrel to an average of just \$29-39/barrel today.** What was in 2013 a marginal economic

proposition dependent upon a sustained high price of oil, is today a winning economic proposition with a substantial margin of safety even at moderate oil prices.



Source: Rystad Energy NASWellCube

(As can be seen above, there are significant differences in economics from basin to basin. The optimal fracking techniques, as well, can vary significantly from basin to basin and even within the same basin.)

Given the favorable economics, abundance of drilling opportunities and the increasingly favorable oil supply backdrop, it is difficult to imagine any scenario in which fracking activity does not increase significantly over the next five years. Even the oil majors such as Chevron (NYSE:CVX) and Exxon (NYSE:XOM), who can drill anywhere in the world, have now made U.S. shale drilling one of the centerpieces of their massive global drilling programs. While these capital programs are not literally set in stone, they are the result of many years of planning and they are unlikely to change except at the margins.

The three critical ingredients in fracking are sand, pressure pumping horsepower, and water. Most investors are familiar with the first two, and instinctively assume the business of water must be similar. That is a mistake.

WTTR is primarily in the business of providing water and water management solutions to the fracking industry and is appropriately associated with those two businesses. But there are critical differences which are not yet understood by investors broadly and that has created an extraordinary opportunity for investors. While the demand drivers for water are essentially identical to those for sand and horsepower, the supply side drivers are entirely different. Sand and horsepower are both commodity businesses with capital the only meaningful barrier to entry. That's why those businesses trade at relatively modest multiples.

But the water business is not at all a commodity business. Water sourcing and management is a logistical business that **requires permits and access rights to disparate sources of water, including lakes, rivers and groundwater. Currently, WTTR has permits or long-term access rights to approximately 1.5 billion gallons of water annually from hundreds of sources, along with their associated rights-of-way for transporting that water to where it is needed.** Its franchise was cobbled together over many years and is now virtually impossible to replicate.

Many of those water and easement rights are exclusive. By way of example, WTTR has a dominant presence in the Bakken, which produces 1.2 million barrels per day (bpd), or about 12% of daily U.S. production. **Water for fracking in the Bakken comes from Lake Sakakawea in North Dakota. This water from Lake Sakakawea cannot be obtained without a permit and it has been decided that no new permits will be granted within 25 miles of an intake location associated with an existing permit. There are five permits and WTTR owns three of those permits. Because of its protected long-term water position, the company has also been able to invest in an in-ground pipeline infrastructure system to make full use of its water rights. As a result, WTTR has a truly enviable and probably impossible to replicate competitive position.**

Demand for water has grown exponentially, driven by improvements in drilling and fracking technology, and continued robust growth is all but assured. Ten years ago, a conventional vertical well might have required about 15,000 barrels of water, or 630,000 gallons. Today, a modern horizontal well requires 600,000 barrels of water, a forty-fold increase, the equivalent of more than 25 million gallons.

Scalable and Reliable Water Sourcing and Logistics Are Critical to Unconventional Production

Evolution of the Oil & Gas Industry's Approach To Water				
	Pre - 2008 Conventional Vertical	2008 - 2010 Early Horizontal	Current Leading Edge Horizontal	Emerging Multi-Well Pad Development
Frac Water per Well ¹	~15,000 bbls	~75,000 bbls	~600,000 bbls	Up to 6 million bbls on a multi-well pad
Equivalent Tank Truck Loads ²	~115	~575	~4,620	~46,200
Lateral Length (Feet) ³	~1,500	~3,500	~10,500	~10,500
Logistical Challenges				
E&P Approach				

Secular trends have driven increases in water demand per well by more than 30x during the past 10 years, driving demand for complex, sophisticated water solutions

1. Water per well based on current management estimates of well completion intensity
2. Assumes single tank truck capacity of 190 barrels
3. United States Energy Information Administration ("EIA") and other third party research



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Source: Company presentation

When water demands were modest, water could be brought in by truck and sourcing was not an issue. But those days are mostly gone. Today, water is delivered through either lay-flat portable hose or pipelines. This requires access to many local sources of water and the associated rights-of-way to transport that water to its destination. In short, it requires a lot of local knowledge and feet on the ground.

All of this makes water a very different business from sand or pressure pumping because the barriers to entry are much higher and, **in some areas such as the Bakken, they are effectively insurmountable.** Working quietly, before the great rush began, WTTR has systematically assembled a nationwide footprint of water and easement rights that is now effectively impossible to replicate.

WTTR has another two things going for it: **scale and scope.** When it went public in April 2017, it was already the largest water company in the industry. Number two was a private firm called Rockwater Energy Solutions. On November 1, 2017, WTTR acquired Rockwater in a merger of equals, thereby becoming the largest company in the industry by a very considerable margin. The rest of the competition is comprised of fragmented local and regional companies, many of them of the mom-and-pop variety. As the 800-pound gorilla, WTTR is by far the leader in the industry and, as the only company with access to the capital markets, it is ideally positioned to extend its lead.

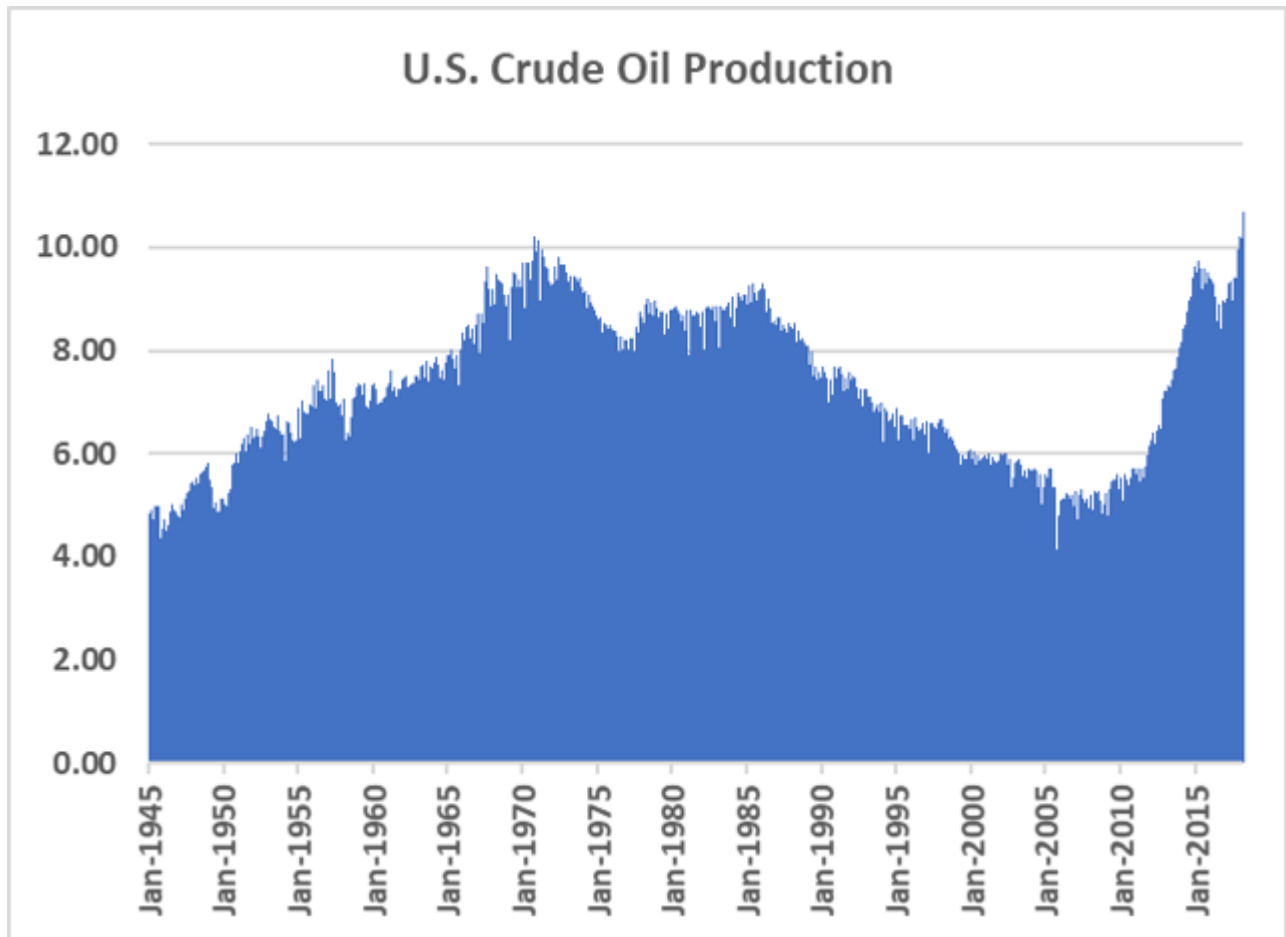
In this business, size begets opportunity and opportunity begets size. WTTR is now able to undertake growth and expansion projects that are simply out of reach of many of the local operators they compete with.

THE MIRACLE OF MODERN FRACKING

Let me start with a little bit of background for those who may be less familiar.

While the concept of fracking or otherwise stimulating wells to increase their output has been around for a long time, it is only since the development of modern fracking techniques that the industry has been able to produce oil economically from tight shale formations. It is literally squeezing oil out of rocks. The story of the development of modern hydraulic fracturing is a truly fantastic one that reflects the best of American ingenuity and doggedness. Had it not been for the efforts of a determined few, the shale revolution might never have happened.

Prior to the development of these techniques, U.S. crude oil production was in a state of long-term secular decline. Having peaked at just over 10 million barrels per day (mmbpd) in 1970, production had declined to just half that amount by 2010. But, over the course of just the past six years, oil production has reversed its decline and grown dramatically, more than doubling to hit 10.5 mmbpd, a new all-time high. The entirety of that increase is attributable to the industry's ability to "crack the code" and develop modern fracturing techniques. It was and is very much an experimental process and those techniques are still being refined and improved upon each day.

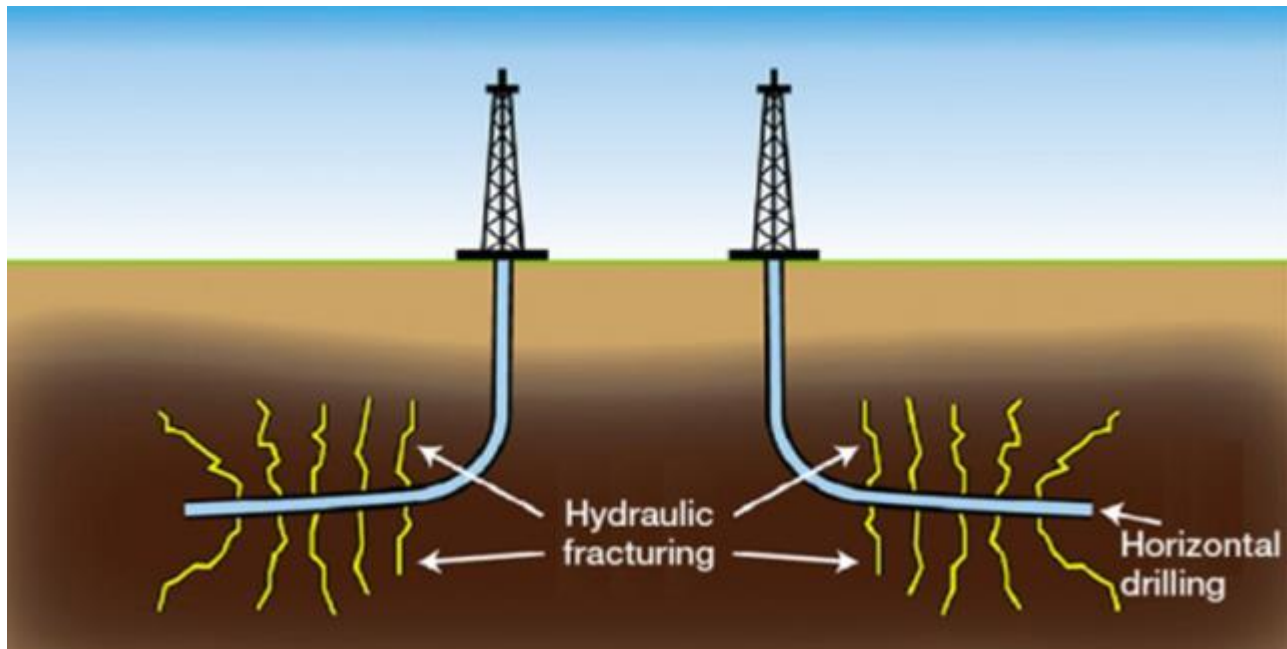


Source: U.S. Energy Information Administration (EIA)

At the current price of crude, this is a \$125 billion increase in annual oil output. The fracking business is now an important economic driver of national significance. Considering the geopolitical implications as well, this is also a strategically critical business. All that aside, as I said earlier, given the favorable economics, the abundant shale geology that the U.S. has been blessed with, and the increasingly rosy outlook for oil supply and demand, **it is essentially inconceivable to imagine any scenario by which shale related drilling and fracking does not increase significantly over each of the next five years.**

Let's take a quick look at what fracking is all about.

In the old days, by which I mean a decade or more ago, wells were mostly drilled just vertically. Today, they are almost exclusively drilled horizontally as well—that is, after drilling vertically down to the targeted depth, the drill bit will turn a ninety-degree angle and drill horizontally, typically for up to two miles or more. This exposes a tremendous amount of oil bearing rock to the wellbore.



Source: Oil & Gas Logistics

Fracking, at its essence, is the act of blasting a slurry of sand and water, along with some specialty chemicals, through the lateral wellbore at extremely high pressures. One of the keys to “cracking the code” has been to drill longer laterals, while fracking them at significantly higher pressures using increasingly more sand and water per lateral foot. Today, a leading-edge horizontal well runs about two miles horizontally and consumes in the range of one ton of sand and 2,500 gallons of water per lateral foot. **In other words, such a well will use about 10 thousand tons of sand and 25 millions gallons of water.** Companies continue to experiment with yet longer laterals, including a recent record breaking lateral in the Marcellus that was almost 3.7 miles long. Lateral lengths are still getting longer and the wells of future years will almost certainly need more sand, more water and more pressure. In return, they will almost certainly produce more oil.

SAND AND HORSEPOWER: ALL YOU NEED IS CAPITAL

This is an article about water, but I’m going to start by discussing sand and pressure pumping. Why? Because investors are a lot more familiar with these businesses, and it is investors’ understanding of these businesses that is unfairly tainting their perception of the water business.

The reason for investors’ greater familiarity with these businesses is because several them have been publicly traded for some time. The pure-play sand companies include, U.S. Silica (SLCA), Emerge Energy Services (EMES), Smart Sand (SND), Hi-Crush Partners (HCLP), and Covia (CVIA, formerly Fairmount Santrol). Some of these stocks were even high flyers at one point. As to pressure pumping, investors have long been familiar with the business through companies such as Halliburton (HAL), Baker Hughes (BHGE), Weatherford (WFT), Schlumberger (SLB), Patterson-UTI Energy (PTEN), Superior Industries (SPN), and RPC, Inc. (RES). As well, a number of pressure pumping companies have recently gone public, including, **Liberty Oilfield Services (LBRT)**, FTS International (FTSI), ProPetro Holding (PUMP), Keane Group (FRAC) and Mammoth Energy (TUSK).

Starting with the sand companies, investors who own their stocks are no doubt focused on two things. First, the companies look cheap, currently trading at an average 4.5x multiple of enterprise value to 2019 forecast EBITDA. Second, the companies are minting money and the demand outlook is stellar. According to a report by IHS Markit, frac sand demand is forecast to double from approximately 150 billion pounds in 2017 to almost 300 billion pounds in 2022, led by a dramatic increase in drilling in the Permian Basin.

So, with frac sand companies minting money at current volumes, and with volume expected to double over the next five years, **why are their stocks so cheap? The answer is that sand is a commodity. Currently, it is a commodity in short supply, and the price is sky-high. But the barriers to entry are low, and a wave of supply is beginning to come on-line.** For the moment, demand still outstrips supply, and this is keeping prices elevated. But economic theory tells us that the price of a commodity will tend toward the marginal cost of production. For frac sand, that marginal cost is about \$20/ton, well below current mine gate prices of \$40-50/ton.

Of course, the reality is that nobody really knows what frac sand demand will exactly be in the out years. Almost certainly, it is going very significantly higher. But, even if the 2022 demand forecast turns out to be accurate at 300 billion pounds, if the industry gets ahead of itself and gears up to supply 330 billion pounds, sand prices are going to take a beating. All we really know is what economic theory tells us—in the long term, supply will catch up with demand and prices will tend toward their marginal cost, which is a whole lot lower than the current price. Given the large up-front capital cost, the low marginal cost of production, and the large number of disparate players, it is difficult to imagine why classical economic theory should not play out over time.

Let's take a quick look at the economics of building a sand plant. In June 2017, U.S. Silica announced it would build a new frac sand plant in the Permian Basin capable of shipping 4 million tons per annum. The plant would cost \$225 million to build and have a reserve life of over 30 years of production. Construction would begin immediately with initial production expected in the fourth quarter. In other words, if you've got \$225 million, you too can be producing 4 million tons per annum of frac sand within six months. The barriers to entry are that low. Frankly, that shouldn't be all that surprising—after all, it's just sand. It sits at the surface and you basically scoop it up, wash it, dry it, filter it and sell it. Many sand companies will claim that they are not really in the sand business but, like WTTR, they are really in the handling and logistical business. But based on where they are earning their money, they are pretty clearly in the business of selling sand.

To further drive this point home, let's take a quick look at Emerge Energy Services (EMES), a fairly typical frac sand producer. In 2014, the industry shipped 109.5 million tons of sand. Emerge shipped 8.6 million tons that year, for an 8% market share, and reported EBITDA of \$123 million, or \$14.30 per ton. The shares closed the year at \$54 after trading as high as \$145. Now, fast forward to 2017, when the industry shipped 148.4 million tons of sand, a healthy 35% increase. Emerge reported shipping 12.1 million tons, still about an 8% share, **but reported EBITDA of just \$30 million, or \$2.47 per ton. The shares closed the year at \$7.19 after trading as low as \$5.65. Even though tons shipped grew by 40% during this period, EBITDA decreased by 75%. That is the nature of a commodity business, and that is why sophisticated investors don't pay fancy multiples for them, particularly on cyclically elevated earnings.** It's not just about demand; it's about supply as well; and no one can predict either of them, so it is double jeopardy.

In response to the dramatic upturn in the demand for frac sand, particularly for drilling in the Permian Basin, the industry has so far responded by increasing supply by almost 75 million tons per annum, or 60%. Truth be told, that's a very stale number and the correct number today is almost certainly much higher. **Recently, every day seems to bring new announcements of increased capacity. The list of new entrants is mind boggling—there's Vista, Preferred, Badger, Eagle, Premier, Black Mountain, High Roller, Aequor, Alpine, Atlas and West Texas Sand, to name a few. That's of course in addition to the more established companies who are also adding supply at a rapid pace.** Furthermore, what started as a Permian Basin phenomenon is now rapidly spreading to other basins. All these companies are going to try to sell all the sand they can produce and that's not going to stop until sand prices decline significantly. When they do, sand company earnings will decline significantly as well and it will become painfully clear that the sand companies are in the sand business and not the logistics business.

Similarly, in the pressure pumping segment, the surging industry demand has caused the industry to respond by reactivating idle horsepower and purchasing new equipment. As with the sand business, the only real barrier to entry is capital. In this case, \$40 million and a six month wait will buy you a shiny new 50,000 hydraulic horsepower frac spread. The newly public pressure pumper companies are now flush with their IPO proceeds, and they've all used some of that money to add new equipment. To be clear, given the surge in fracking, this new equipment is badly needed. **Unlike the frac sand industry, there's no evidence that the pressure pumping industry is overbuilding capacity—it's just when the only barrier to entry is capital, that's what can easily happen.**

(Author's note: I am bullish on the pressure pumping industry. **In truth, I think of pressure pumping as a quasi-commodity business rather than a pure commodity business.** Labor is also increasingly a barrier to entry. As well, some pressure pumpers are more knowledgeable and efficient than others. It is a business where differentiation is possible. The pressure pumping industry is also a much less extreme version of the sand industry, because marginal costs are significantly higher. A new frac spread costs \$40 million and it's a lot easier to be financially disciplined when you are spending that kind of money. But the principle is the same. Returns to shareholders are a function of both demand and supply. Even when substantial growth in the former is inevitable, the latter is uncontrollable.)

WATER: A TOTALLY DIFFERENT ANIMAL

But the water business is different and the proof, as they say, is in the pudding. Other than WTTR itself, no other water companies have either gone public or even filed to do so. Why not? Because they don't really exist. Sure, some regional water companies must have been created over the past five or six years and perhaps one or two of them will eventually amass enough scale to go public, but for the most part, they just don't really seem to exist.

(If you are interested in anything and everything to do with the fracking business, Infill Thinking is a nonpareil must-read resource. If there were a meaningful new entrant in the pre-frac water business, they would have identified it for me. So far, I have not read of any. The closest I've come is a company that plans to supply water to frac sand producers, who need it to wash their sand.)

Why don't such companies exist? The answer is because the barriers to entry are much higher. It's evidently just not that easy to enter the water business in scale.

Previously, I rattled off the names of almost a dozen pressure pumping companies and well more than a dozen frac sand companies. In a commodity business, on some level everybody competes with everybody. Let's take a quick look at what WTTR says about the competition in its 10K:

Many large domestic and international oilfield services companies offer some water-oriented and environmental services, though these are generally ancillary to their core businesses. As a result, the **water solutions industry is highly fragmented and our main competitors are typically smaller or mid-sized and often private service providers that focus on water solutions and logistical services across a narrow geographic range.** We seek to differentiate ourselves from our competitors by delivering the highest-quality services and equipment possible, coupled with superior execution and operating efficiency in a safe working environment.

It's notable that they don't mention a single company by name as being a serious competitor. Think about it, after six years of a gold rush that saw tremendous amounts of capital poured into everything fracking related, WTTR cannot name a single large-scale competitor.

Think about the business of delivering sand. Before the advent of in-basin sands, most sand was shipped from Wisconsin, by rail, and then transloaded onto a truck for delivery to the well site. The emergence of in-basin sands has essentially eliminated the rail portion of the journey, but the last mile is still delivered via truck on public roads. A two-mile lateral well requiring 20 million pounds of sand will require about 450 truckloads of sand and even that amount is already putting a significant strain on the local ecosystem. Trucks and drivers are in extremely short supply, and many critical roads are beyond congested.

Now think about water. An equivalent well requiring 450 truckloads of sand will need ten times that many truckloads of water. That's an impossible burden on the ecosystem. Therefore, water these days is delivered by lay-flat hose that can be rolled out as needed.

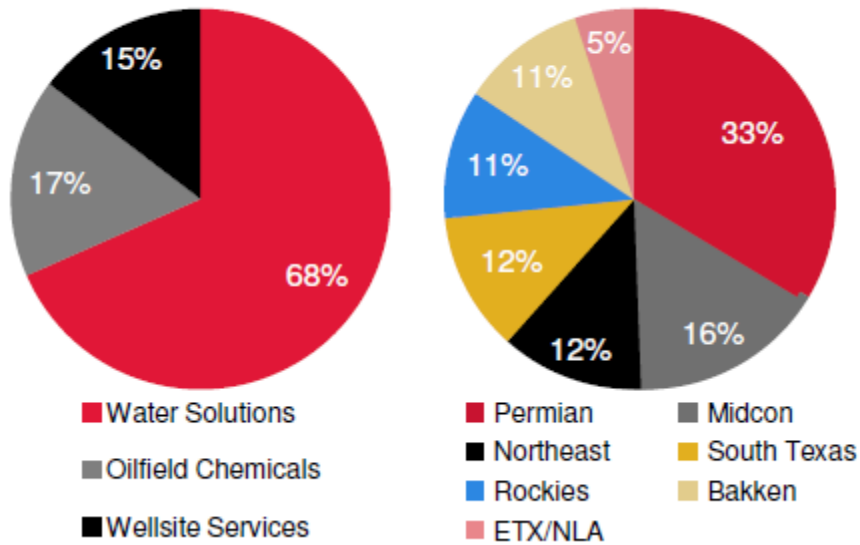


The limits of lay-flat hose are probably 30-40 miles and, of course, the shorter the haul the better. Obviously, a one-mile hose run is going to be a lot cheaper than a thirty mile hose run. Thus, water has to be locally sourced, and the more locally the better. Furthermore, the hose does not run politely along the public road system like trucks. Invariably, the hose will have to run across someone else's private property, and that means **rights-of-way have to be pre-negotiated**. Again, a lot of local knowledge and feet on the ground are required. Assembling a national footprint is just not that easy and that's why WTTR is unique.

AN INTRODUCTION TO THE COMPANY

In addition to the water business, Select also has an oilfield chemicals business which accounts for 17% of revenues. This is a potentially very interesting and complementary business as oilfield chemicals such as friction reducers are also flushed down the wellbore during the fracking process.

1Q18 Revenue by Segment & Geography^{1,2}



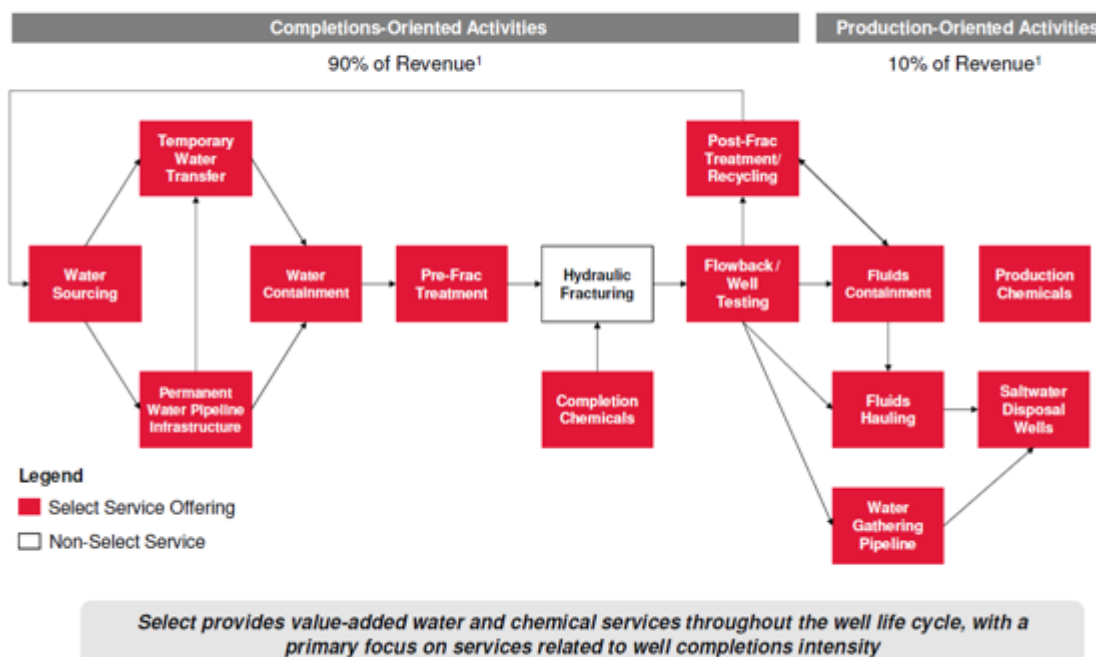
Source: Company presentation

The company also has a well site services business providing lodging and equipment rentals. I suspect this is a profitable but relatively non-strategic business that could be divested with the proceeds being reinvested into the company's more strategic core businesses.

As shown below, while the company has a presence in every aspect of water handling and logistics, 90% of its revenue comes from activities that directly surround the hydraulic fracturing business. About two-thirds of their water revenue comes from pre-frac water sourcing, containment and treatment, and the remainder is split between post-frac water treatment and recycling and production-oriented activities.

According to the company, the pre-frac water business is less competitive, which I suspect owes to their large network of proprietary water sourcing and easement rights.

Market Leading Comprehensive Water and Chemical Solutions Company



1. Represents % of total Water Solutions and Oilfield Chemicals combined segment revenues for the quarter ended March 31, 2018

SELECT
ENERGY SERVICES

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Source: Company presentation

I'm not going to go into much detail about what happens to the water. Suffice it to say that a modern horizontal well requires about 25 million gallons of water to be transported from the source to the well site. That's a lot of water. Once at the well site, it is stored in above ground pools and eventually mixed with sand and pumped downhole. Shortly after the fracking is completed, about half that water will flow back to the surface where it needs to be handled. And that's hardly the end of the water story. Once a well is producing, it will continue to produce about four barrels of water for every barrel of oil, and that water also needs to be either recycled or disposed of. All this flowback and produced water is dirty water, thick with chemicals and clays and must be either recycled or properly disposed of. That's why, over the lifetime of a well, approximately 55% of operating expense are related to water. From WTTR's perspective, every touch point for water is an opportunity for profit.

Water logistics are also becoming significantly more complex as single well fracking evolves to multi-well pad development where multiple wells are drilled and fracked from a single drilling pad. Such a project can use up to 250 million gallons of pre-frac water and such a project is likely beyond the capabilities of many smaller operators.

Now that you (hopefully) understand why WTTR is different, let's look at the numbers.

Shares Outstanding: 106.6 million (includes minority shares—approx 40 mil.—convertible into Class A shares)

Market Capitalization: \$1.434 billion

Enterprise Value: \$1.502 billion

The company is profitable and has a relatively clean balance sheet with substantial equity and virtually no debt.

Cash: \$6.1 million

Debt \$75.0 million

Stockholders' Equity: \$1.081 billion

Current cash flows are robust and more than enough to finance the company's capital investment program. In fact, the company paid for the entirety of its first quarter capital investments out of operating cash flow.

Q1:18 Reported EPS: \$0.15

Q1:18 Adjusted EBITDA: \$59.6 million

Q1:18 Adjusted EBITDA/share: \$0.56

On their most recent conference call, management stated that they expect the company to turn significantly free cash flow positive toward the end of the second quarter--right about now--and to be increasingly free cash flow positive throughout the balance of 2018 and beyond. 2019 should be a year of very significant free cash flow.

Beyond 2018, revenue, cash flow and earnings growth are all expected to be substantial. I believe the consensus estimates will prove conservative because they do not account for the many growth opportunities, both organic and inorganic, that the company has.

	2017	2018	2019
Revenues (000)	\$1,250,000	\$1,640,500	\$1,978,000
Adjusted EBITDA (000)	\$172,000	\$271,500	\$349,800
EBITDA per Share		\$2.54	\$3.28
Earnings per Share		\$1.02	\$1.70
EV / EBITDA Multiple		5.6x	4.3x
P/E Multiple		13.3x	8.0x

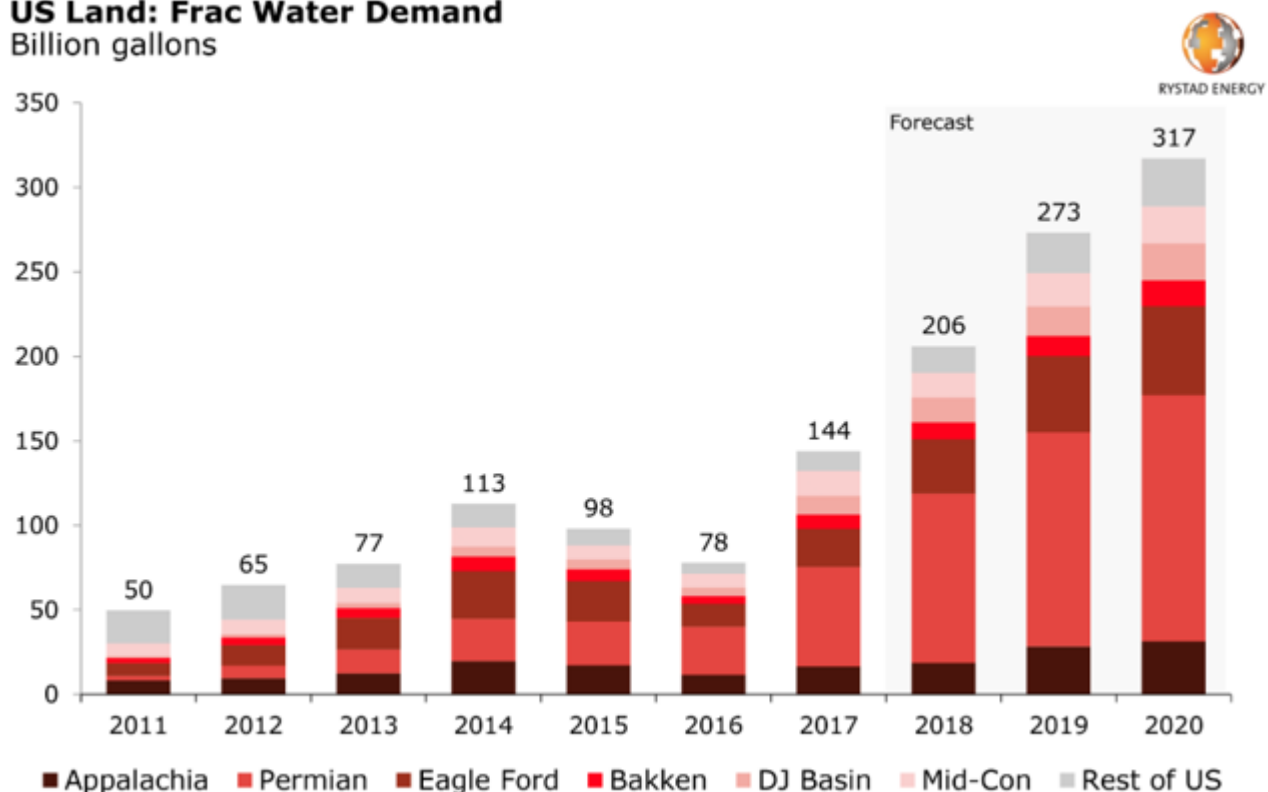
Source: Company filings, YCharts, author's calculations

As I will discuss later, WTRR currently sells at a discount to both its sand and pressure pumping peers. This is wholly unmerited. Water is a vastly superior business model and should sell at a significant premium.

Let's dig a little deeper to figure out why.

First, like sand, demand for water is explosive, growing almost 85% in 2017. With more drilling and longer laterals, Rystad Energy expects water use to grow from 144 billion gallons in 2017 to 317 billion gallons in 2020, more than doubling in just three years.

US Land: Frac Water Demand Billion gallons



Source: Rystad Energy ShaleIntel

In the scope of national water use, that's a drop in the bucket. Even in Texas, water for fracking amounts to only 1% of the total groundwater use. The problem is that water is a local resource and much of that water demand is coming from West Texas, a hot and dry geography where groundwater availability can be limited.

According to a recent article in The Texas Observer, "a new fracking frenzy is putting a strain on groundwater." For example, in Howard County, fracking-related demand for water has increased from 100 million gallons in 2010 to nearly one billion gallons in 2015. Certainly, that number is considerably higher today. In fact, water there is in such short supply that only 8% of farmland is irrigated. Because of its location over the thinnest portion of the underground aquifer, it is an area that is genuinely in jeopardy of running dry. While Howard County may be the exception for now, it is only 150 miles from the

northern Delaware Basin, where Exxon and Chevron are launching massive drilling programs that will use billions of gallons of water.

The bottom line is that water rights matter, and soon they may matter a lot. Over the next year or two, the availability of water is going to be a big story—and that will be a major positive for WTTR. As noted earlier, WTTR has secured long-term access rights to approximately 1.5 billion gallons of water annually, mostly at a fixed price. That's a big deal and a huge competitive advantage over companies such as Tetra Technologies (TTI) and Basic Energy (BAS), who can transfer water but not source it. If water becomes scarce and prices rise, it will be an even bigger competitive edge.

According to the company's form 10K,

On the pre-frac side our Water Solutions segment's inventory of water sources is a key competitive advantage that enables us to offer our customers reliable access to the volume of water essential for fracking operations. Water sources are often difficult to locate, acquire and permit, particularly in the quantities needed for multi-well pad development programs. We have spent years obtaining strategic water sources and have secured permits or long-term access rights to approximately 1.5 billion barrels of water annually from hundreds of sources, including large scale sources such as the Brazos, Missouri, Navasota, Ohio, Rio Grande, Sabine, San Antonio and Washita Rivers.

Furthermore, the process of securing additional water rights is an ongoing one that requires significant local knowledge. The ability to consistently add water sources where they are needed is a critical competitive advantage.

The 10K continues,

In addition to surface water rights, groundwater resources are a key component of our extensive water portfolio. These sources have been secured or developed within our Water Solutions group and are designed with dedicated containment and transfer logistics to offer a complete water management solution. The first step in procuring a water source is identifying an area of interest based on anticipated drilling and completion activity because of lease activity, applications for permits and industry sources. After a specific water source is identified, we perform an assessment of the prospective source, including confirming availability, regulatory status, and any limitations on potential water rights. We use our AquaView technology to quantify volumes and flow rates to verify current and potential water availability and volumes. After confirming the relevant ownership information, we begin negotiations with the applicable landowner or holder of the water rights. After finalizing the agreements and access rights, our team will obtain necessary regulatory approvals, permits and rights-of-way as needed based on the regulatory authorities involved and individual circumstances. **Going forward, we believe that our expertise and relationships in water sourcing will provide us with a competitive advantage in identifying and securing additional sources of water.**

At year end, WTTR had about a billion dollars of property, plant and equipment on its books. If it were just a matter of replicating that infrastructure, the company would easily have half a dozen public competitors just like its sand and pressure pumping analogues. But it doesn't, and the only plausible reason is that the business has a wide protective moat around it and requires a lot more than just capital.

Furthermore, because of its running-away leadership position in certain basins, the company has the scale to create its own pipeline infrastructure, giving it an enormous edge over the competition. According to the 10K,

To support our water sourcing and transfer services, we have also made significant investments in strategic permanent pipelines that provide reliable and cost-effective water delivery. Our most significant pipeline assets are in the Bakken and allow us to take advantage of our water permits in that region. Our Bakken pipelines consist of two active underground pipeline systems, the Charlson and the Iverson systems, in McKenzie County, North Dakota that can currently deliver up to 62 million barrels of fresh water per year. We are in the process of developing a third underground pipeline to support Williams County and western Mountrail County in North Dakota that would allow us to fully utilize our annual water rights in this region. We have signed long-term contracts supported by Areas of Mutual Interest with major Bakken producers that we believe will use a significant portion of our current pipeline capacity. We have also made investments outside of the Bakken, including our pipeline serving the SCOOP area of Oklahoma, the “Pecan Hill Pipeline,” and our pipeline serving the Haynesville, the “IP Pipeline.”

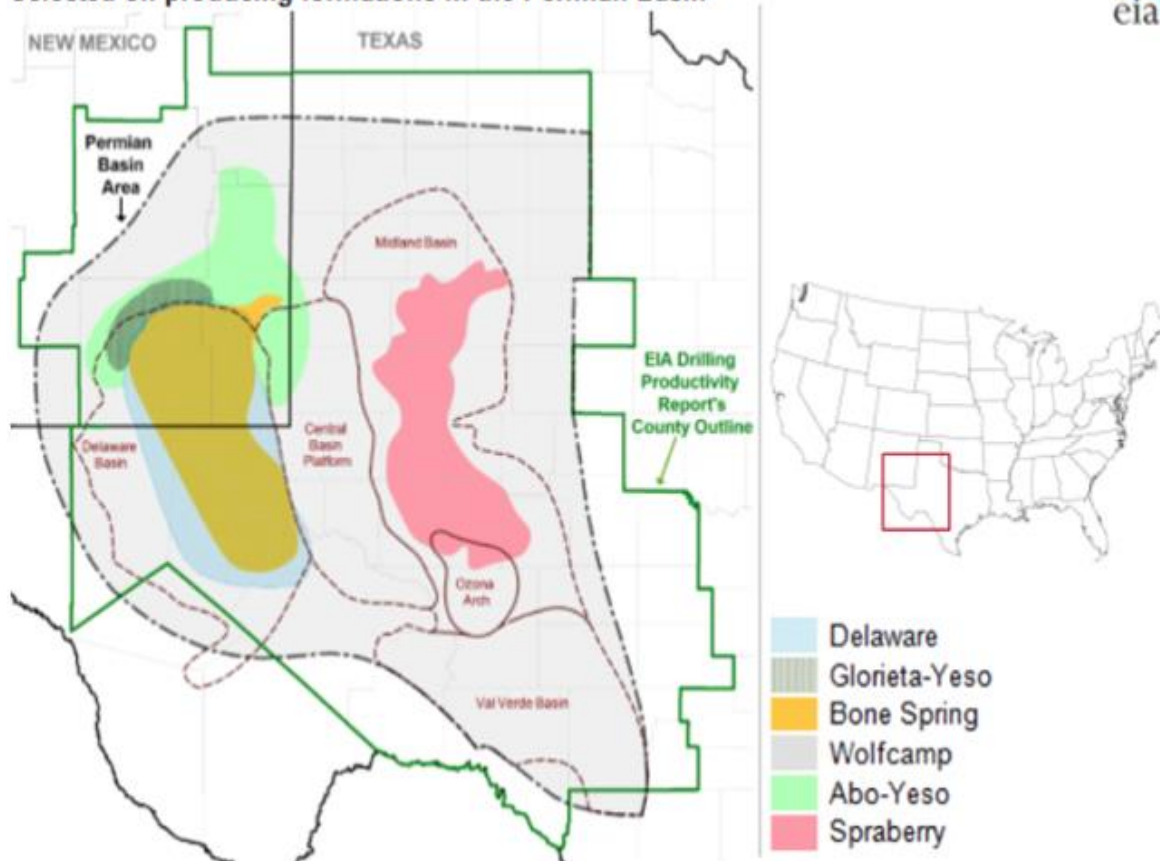
Finally, as shown in the pie chart just below the current section heading, WTTR has a geographically diversified revenue stream, with balanced exposure to all the major shale basins. This means it is not overly dependent upon any one basin. Margins from basin to basin are relatively consistent and the company has the flexibility to move equipment around as necessary. This is a great advantage as activity shifts from basin to basin, which it can do.

THE PERMIAN BASIN

No discussion of fracking would be complete without a section devoted to the Permian Basin. The Permian is by far the most important oil producing geography in the country. With an estimated 60-70 billion barrels of recoverable oil still in place, it is second only to Saudi Arabia’s Ghawar field in size and importance.

As shown below, the Permian consists primarily of two smaller basins, the Midland Basin and the Delaware Basin. Since 2013, the breakeven crude oil price has declined from \$98 to \$39 in the Midland Basin and \$81 to \$33 in the Delaware Basin. In other words, despite the billions of barrels of oil in place, as recently as five years ago, the economics were only marginal.

Selected oil-producing formations in the Permian Basin



Source: [EIA](#)

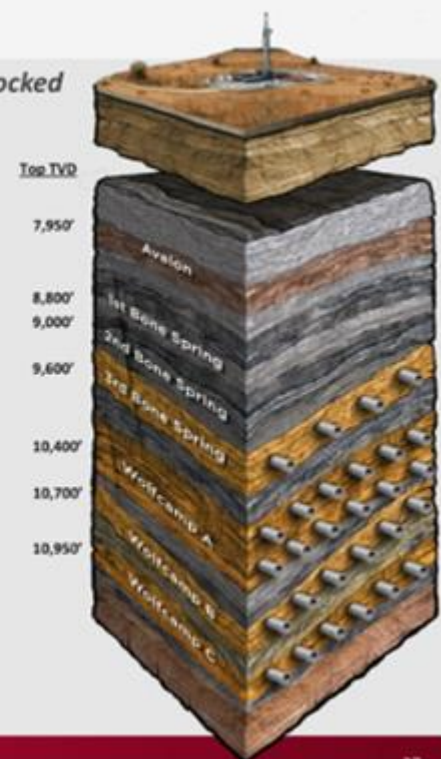
While the Midland was developed first, activity in the Delaware is starting to surge. It is the hottest play on the planet right now because the best geology there consists of large stacked pay levels of oil-bearing rock, one atop the other.

Delaware Stacked Pay Running Room

Additional opportunities to be unlocked

- **High-quality Stacked Targets Across Position**
 - Pay interval more than 3,400 ft thick
- **Increased Locations by 40% to 1,675 from Merger Plan**
 - Drillable footage up more than 100% including longer lateral lengths
 - Increased confidence in Wolfcamp A downspacing
 - Added Wolfcamp B and C locations to development plan
- **Additional 485 Potential Locations in Other Prospective Zones**

Targeted Wells per Section		NBL	Peer Range
Development Plan	3rd Bone Spring	4	4-7
	Wolfcamp A Upper & Lower	12	7-15
	Wolfcamp B	6	6
	Wolfcamp C	6	4-6
Gross Inventory		1,675	
Potential Upside	1st Bone Spring & Avalon	4	6-16
	2nd Bone Spring	4	4-6
Total Inventory		2,160	



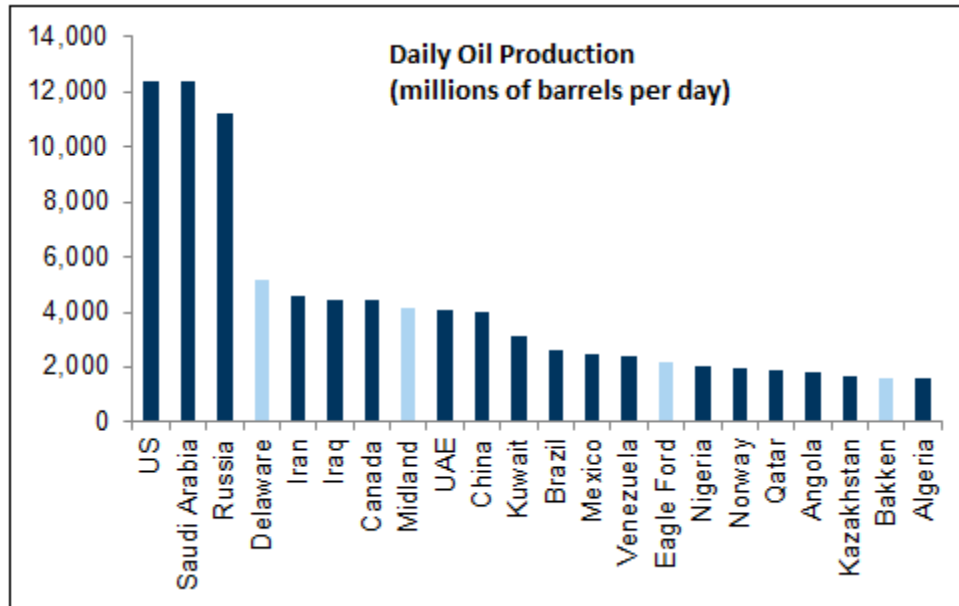
NBL

27

Source: Noble Energy, Inc. company presentation

Both the Delaware Basin and the Midland Basin are incredibly prolific. How prolific? According to a recent Goldman Sachs research report, at full production, just the Delaware Basin alone would be the fourth largest oil producer in the world. The Midland alone would be the eighth largest.

Below is a chart, courtesy of Goldman Sachs, showing where the Delaware Basin, Midland Basin, Eagle Ford Basin and Bakken would rank on a global basis, at full production, if they were separate countries. The Delaware Basin and Midland Basin are not there yet, but they will in over the next number of years, and that's what makes this such an exciting opportunity.



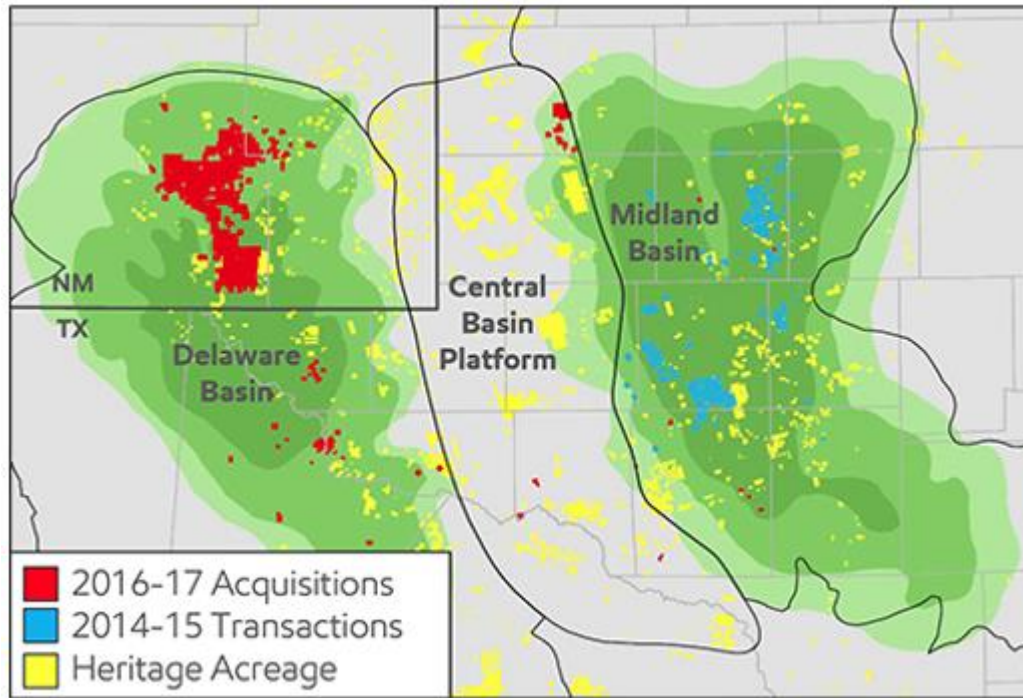
Source: Goldman Sachs research report

Remember, all this bounty is located in just a dozen or so counties in West Texas.

Currently, and for the foreseeable future, the Permian, and particularly the Delaware Basin, will remain the hottest drilling play on the planet. Chevron and Exxon both own huge leasehold interests here and have committed to massive drilling programs with the goal of greatly increasing production over the next several years. Other notable Permian Basin drillers include, Pioneer Natural Resources (PXD), Cimarex Energy (XEC), Apache (APA), ConocoPhillips (COP), Devon Energy (DVN), EOG Resources (EOG), Occidental Petroleum (OXY), Diamondback Energy (FANG), Viper Energy Partners (VNOM), Parsley Energy (PE), Jagged Peak Energy (JAG), and many others. It is going to be a bonanza.

WTTR derives about one-third of its revenues from the Permian Basin and it is going to be a source of spectacular growth. I don't think the potential growth here is in analysts' numbers and, frankly, I wouldn't know how to model the growth either.

WTTR has been busy cementing its leadership position in the Permian. Just prior to coming public, the company purchased Gregory Rockhouse Ranch (NYSE:GRR), a private company focused on providing water and water-related services in the Permian Basin. The GRR acquisition was particularly strategic in that it also added access to what the 10K describes as “a vast array of fresh, brackish and effluent water sources with access to significant volumes of water annually” and “water transport infrastructure including over 1,200 miles of temporary and permanent pipeline infrastructure, and related storage and facilities and pumps,” all on the New Mexico side of the Delaware Basin. In 2016-17, Exxon spent \$6.6 billion to add to its position (in red, below), mostly on the New Mexico side of the Delaware Basin.

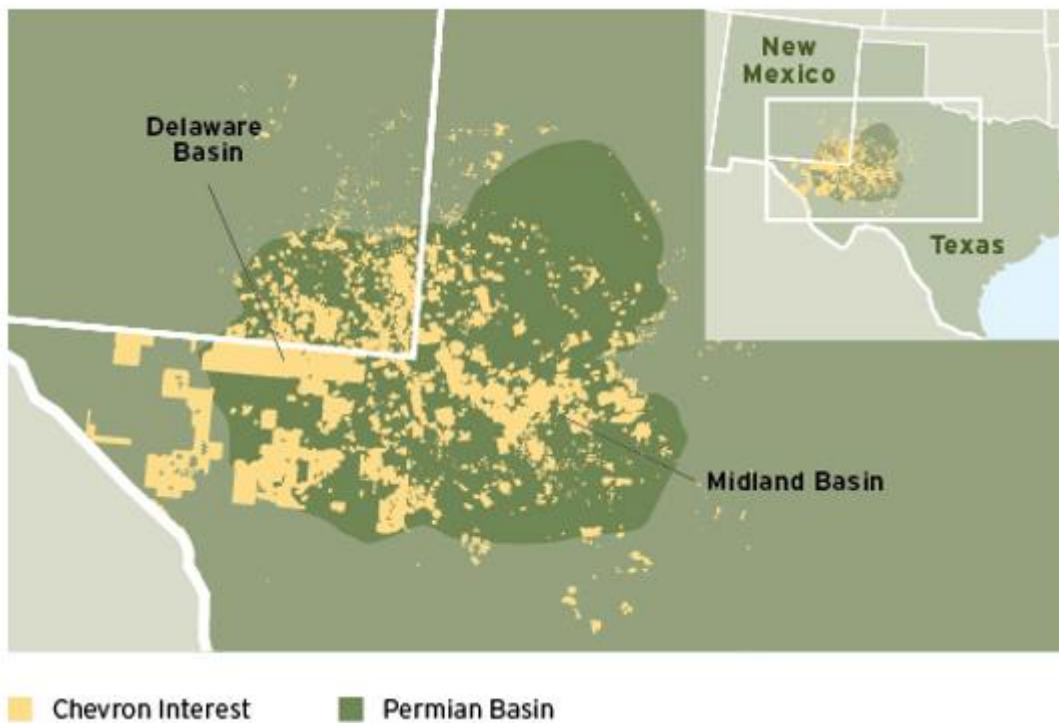


Note: Over 140,000 boe/d net across 1.8M acres in the Permian.

Source:

ExxonMobil Corp

Chevron, which has been sitting on a massive acreage position in the area, is also now beginning to drill aggressively.



Source: Chevron Corp.

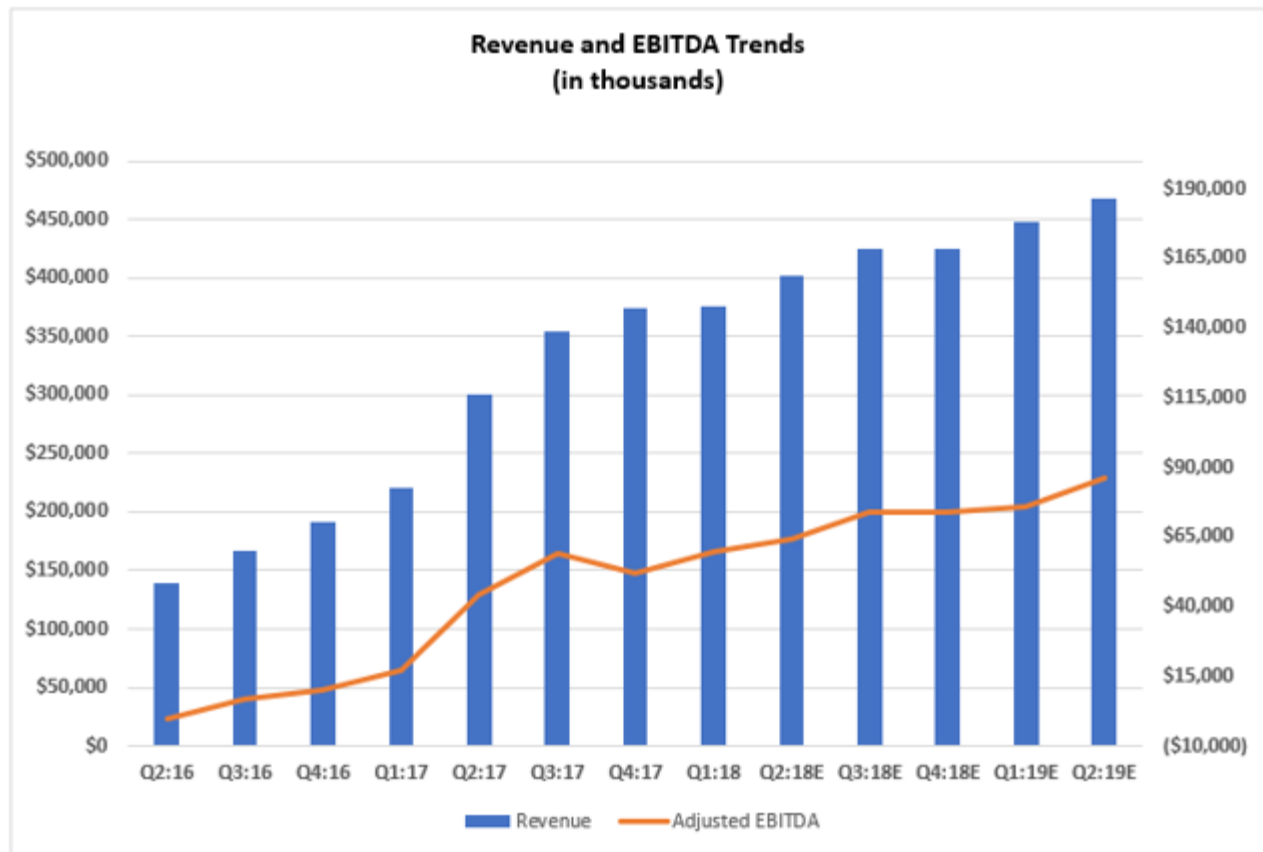
In its 10K, the company states, “We believe this acquisition has significantly enhanced our position in the Permian Basin.” That is almost certainly a vast understatement.

The company has also recently made several smaller acquisitions, including Tex-Star Water Services and Resource Water Transfer, both of which added strategic customer relationships in the Permian.

This is a fragmented industry with many smaller operators. WTTR is now the 800-pound gorilla and no one else is even close. They have a sizable lead over the rest of the industry, and they have the financial resources to keep expanding upon that lead. Currently, the company is working to install a permanent pipeline infrastructure in the Permian—something most smaller players could not even dream of—and that will further widen the gulf between it and the competition.

FINANCIAL ANALYSIS

By virtue of its acquisition of Rockwater, WTTR effectively doubled in size overnight. The chart below shows revenue and EBITDA as if WTTR and Rockwater had always been a combined entity.



Source: Company presentation, consensus estimates

As can be seen, over the past year, the pro forma combined entity increased revenues from \$221 million to \$376 million, far outpacing the industry. Adjusted EBITDA increased from \$17 million to \$60 million. As for the going forward projections, they are just that. I expect that company will significantly exceed these estimates, although I am not entirely sure how it will all be done. According to the company, they

are in the process of raising prices for their oilfield chemicals, which will result in margin improvement in Q2. They also recently invested to be able to manufacture friction reducer in their Midland plant. By bringing production in-basin, the associated transport and delivery costs will be minimized, and this will give the company a significant cost advantage. I'm not sure what this will yield, but the company seems excited about it.

The company is currently implementing across the board price increases in its water business as well. According to the company, the current increases are more about staying abreast of wage and cost inflation, but they anticipate continued price increases throughout the second half that will have the effect of improving margins. I expect continued accretive acquisition activity, even if they are only strategic tuck-in acquisitions. Without a doubt, the company is now the go-to player for anyone interested in selling their company.

The company is also focused on improving margins generally, which it believes have significant room to improve. As management explained on its recent conference call, while business is good all-around, the space isn't "humming and moving like a well-oiled machine." Both equipment and labor are very tight and supply chains are congested. That has created numerous inefficiencies that can and will be improved upon. There is a lot of room for margin improvement here and management is actively working to make it happen.

But most of all, I just expect the company to continue to methodically dominate by virtue of its scale and scope. When you are installing in-ground pipelines and the rest of the industry is playing with lay-flat hose, you've got a huge advantage. When companies like Chevron and Exxon are engaging in multi-pad drilling requiring 250 million gallons of water, I'm not sure who else is going to be able to satisfy them.

FREE CASH FLOW ANALYSIS

Another reason why WTTR merits a superior multiple is that, unlike the pressure pumping business, **it does not require significant ongoing maintenance capital investment.** Thus, for a given level of cash flow, WTTR can generate significantly more free cash flow—and that is the cash flow that can be used for growing the business or returned to stockholders in the form of dividends or share repurchases.

On its fourth-quarter conference call, management guided to approximately \$155 million of capital expenses for 2018. Of that amount, they explained, about half is for maintenance and half is for new growth initiatives. Further, of the amount for maintenance expenses, some part of that is "catch-up" maintenance for expenses that were deferred during the downturn.

FREE CASH FLOW ANALYSIS	2018	2019	2020
EBITDA	271,540	349,770	404,000
"Catch-Up" Maintenance Capital Invest	(17,500)	-----	-----
Regular Maintenance Capital Investme	(60,000)	(60,000)	(60,000)
Growth Capital Investment	(77,500)	(50,000)	(50,000)
Free Cash Flow	116,540	239,770	294,000

Net Cash (Debt) Balance	(72,226)	44,314	284,084
Ending Cash Balance	44,314	284,084	578,084

Source: Company financial statements, conference calls, author's estimates

Assuming that growth investment moderates at the cycle matures, I believe the company is on track to generate almost \$650 million in free cash flow over the next three years.

Of course, to the extent that the company can find compelling growth investment opportunities, then that would be a good thing, leading ultimately to higher returns. For example, management would like to be able to invest an incremental \$50-60 million to create an in-ground pipeline infrastructure in the Permian Basin much like it already has in the Bakken and other basins. This would allow the more economical transport of much larger quantities of water. Ownership of such a permanent pipeline infrastructure would give the company a significant competitive advantage over its smaller peers, who cannot afford such an investment. I'm expecting such an announcement sooner rather than later.

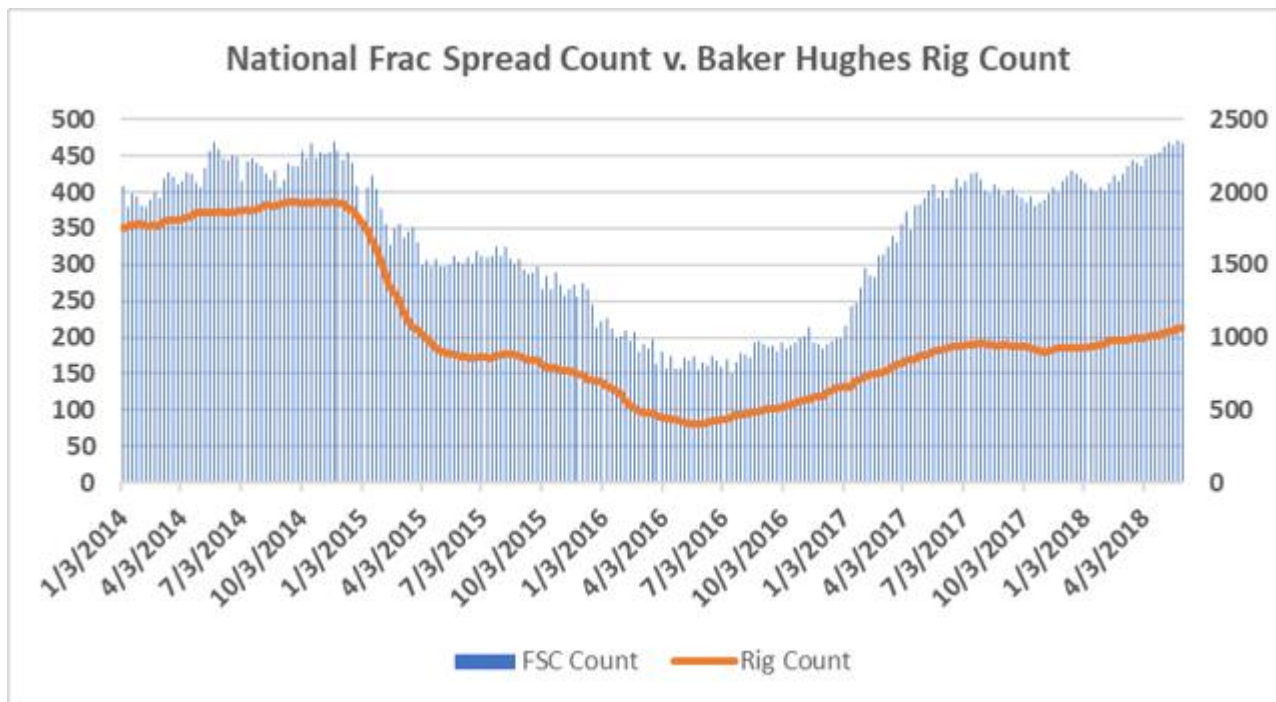
Q1:18 EARNINGS AND GUIDANCE

WTTR recently reported first quarter 2018 revenues of \$376.4 million and adjusted EBITDA of \$59.6 million. Net income was \$10.1 million and earnings per share were \$0.15. 67 mil shs. This was the first full quarter for the combined company and so the results are not directly comparable to the fourth quarter. Adjusting for the impact of the acquisition, management comments on the fourth quarter call suggested EBITDA in the low \$50 million range, so this result was substantially better than guidance.

2018 FORECAST

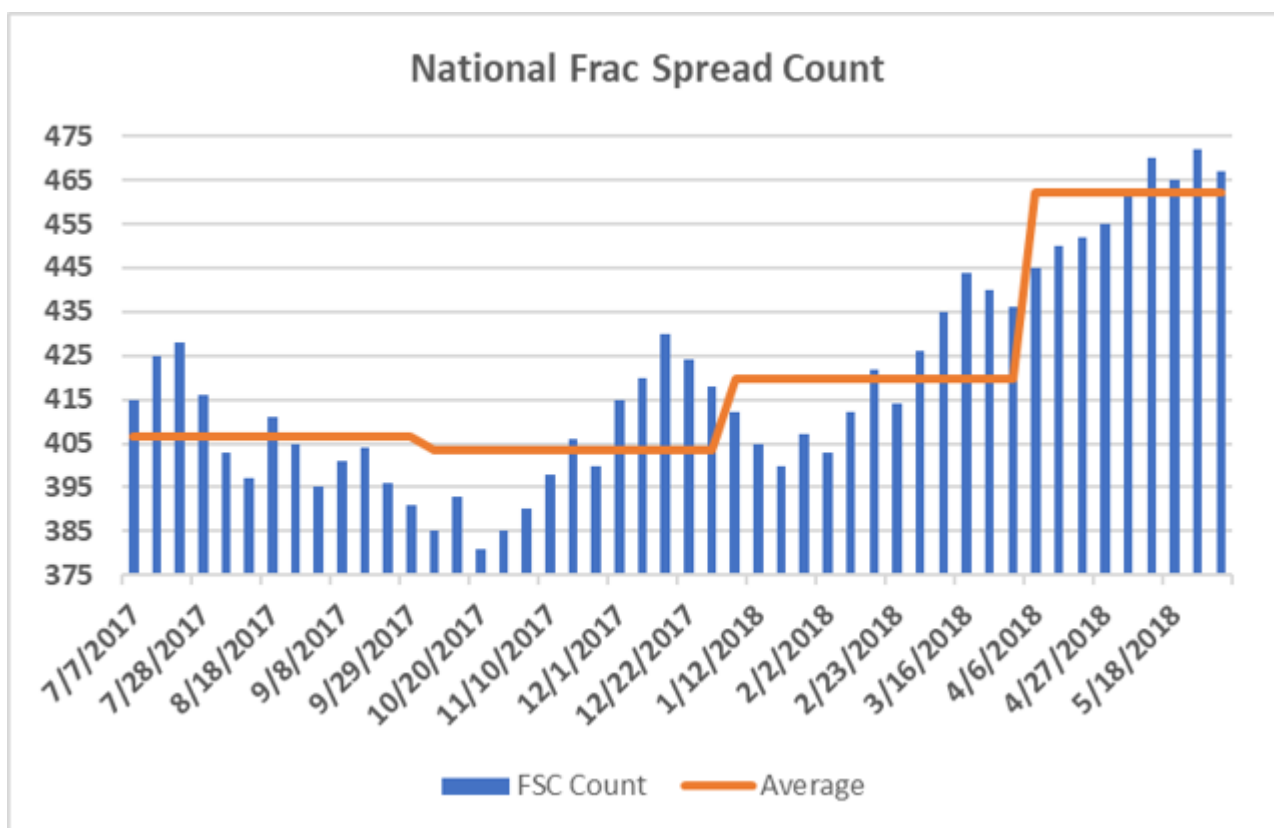
I expect Q2 to be an excellent quarter, driven by better activity, improving margins and merger-related cost savings.

On its Q1 conference call, management noted that they track their business internally using the frac spread count. The Primary Vision national frac spread is a relatively recent data set available to investors and the industry. It is like the well-known Baker Hughes rig count, but the focus is on completions activity rather than drilling activity. As such, it is more directly relevant for fracking industry.



Source: Primary Vision, Inc.

As can be seen, both above and more clearly in the expanded chart below, the frac spread count has accelerated significantly in Q2. Maintained at its current level, the average frac spread count for Q2 would be 462, an increase of 10% over the Q1 level.



Source: Primary Vision, Inc.

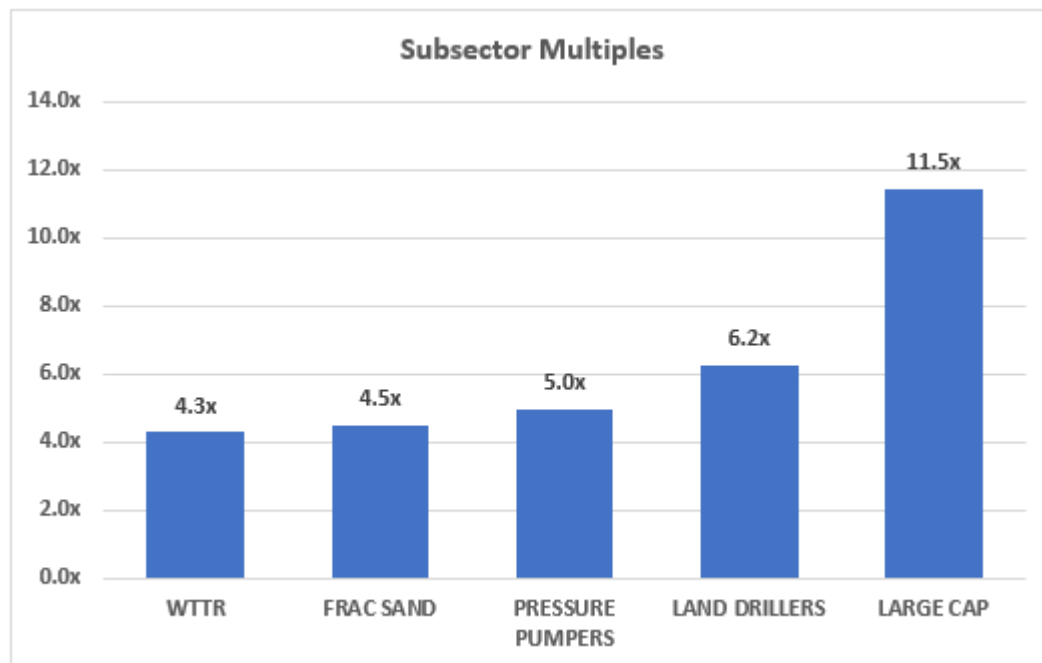
Assuming the company's business roughly matches the 10% increase in the frac spread count, I estimate that Q2 revenues could be approximately \$414 million which would somewhat better than the consensus estimate of \$402 million. Assuming 35% incremental margins, EBITDA could be approximately \$72-73 million, which would be significantly better than the consensus estimate of \$63 million.

While I am not going to make a forecast for the second half, I expect both continued growth and significant margin improvement.

VALUATION AND TARGET PRICE

As can be seen below, the various energy subsectors can have significantly different multiples.

The large multinational oil service companies such as Schlumberger and Halliburton carry the largest multiples because their size, scope and technology endows them with a significant overall franchise value.

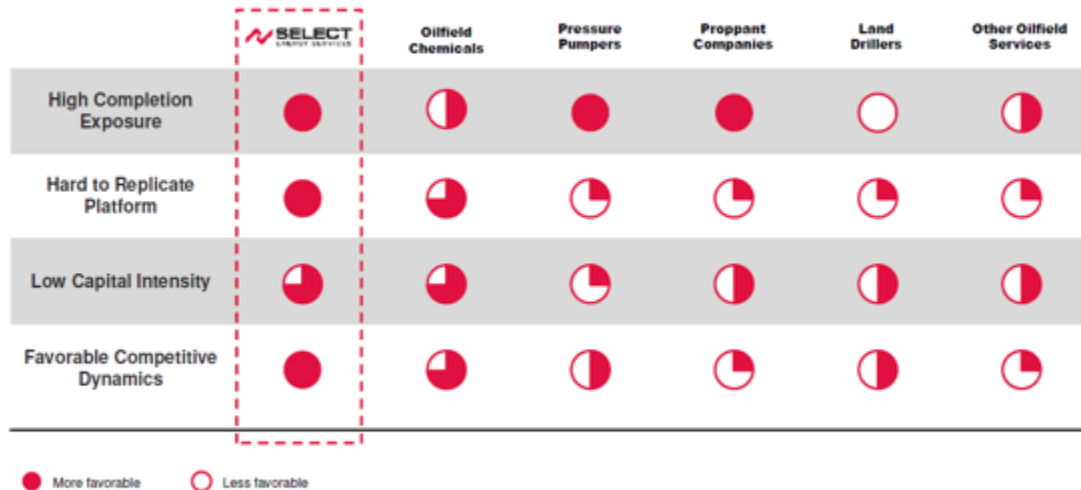


Source: Consensus estimates, author's calculations

Astonishingly, WTR sells even below the average multiple of the frac sand producers, who carry the most commodity exposure of all the subsectors. Sand and water are both consumables, and clearly the market puts them in the same basket. I expect this will change as more investors come to understand the story.

I like the chart below, which compares various oilfield subsectors along four important metrics. The first is "High Completion Exposure," by which they mean high exposure to fracking. This is important because fracking has the best fundamentals of any subsector of the energy services industry and that is unlikely to change in the next year or two. Demand for all things fracking related is through the roof.

Attractive Underlying Fundamentals



Differentiated platform driven by attractive underlying fundamentals

Source: Company presentation

The remaining three metrics—“Hard to Replicate Platform”, “Low Capital Intensity”, and “Favorable Competitive Dynamics”—are all highly qualitative metrics that speak to the type of multiple a company should trade at. Companies with hard to replicate business models tend to face far less competition; and companies with low capital intensity have many more options to either grow their business or return capital to shareholders. All of this merit a significantly higher multiple.

WTTR is a winner on all four metrics and the shares deserve a valuation multiple at the very top end of the range, or perhaps even higher. In fact, I believe that WTTR probably has a much better long-term business model—meaning faster growth, less cyclical, and with better margins and--than even Schlumberger or Halliburton and should trade at a superior multiple.

All things considered, I believe that in the current market environment, WTTR should have a trading multiple of at least 8-10x projected 2019 EBITDA, resulting in an initial price target of \$26-33 per share. I expect that the company will ultimately do significantly better than estimates and, as the company proves out its business model, it may prove it deserves an even higher multiple.

INSIDER BUYING

On March 13-14, CEO Holli Ladhani purchased 29,388 shares on the open market at an average cost of \$13.87. Around the same time, director Alan Burnett also purchased 2,500 shares at \$14.14.

It's always a good sign when multiple insiders buy on the open market.

AN IMPORTANT RECOMMENDATION FOR MANAGEMENT

Let me start with a story, probably apocryphal, but it doesn't matter. As it goes, in the 1950's or so, a man approached a large toothpaste company with a stunningly simple idea that would cost almost nothing to implement yet allow them to increase sales by 40%. The idea? Make the hole larger. You see, by increasing the diameter of the hole from 5mm to 6mm, an average person would use 40% more toothpaste. The point is, sometimes the best ideas are surprisingly simple and lying in plain sight.

So, I'm going to present a similar idea. If implemented in full, it will increase earnings and cash flow per share by as much as 13% and I expect the shares would respond significantly and immediately.

Here's the idea.

**REDUCE YOUR ACCOUNTS RECEIVABLE AND USE THE
CASH GENERATED TO REPURCHASE STOCK**

WTTR is in the business of providing fracking-related products and services to domestic E&P companies. In that sense, they are no different from the sand or pressure pumping companies. Below, I have surveyed three each of the larger pure-play sand and pressure pumping companies for comparison. Like WTTR, each does business almost exclusively with the same universe of domestic E&P companies. As can be seen, the range for days receivables outstanding ranges from 43 to 59, which is exactly what I would have expected.

A/R ANALYSIS	SND	EMES	HCLP	LBRT	PUMP	FRAC	WTTR
Revenues	42,628	106,750	218,113	448,883	385,219	513,016	376,395
Accounts Receivable	27,897	66,768	134,982	257,788	253,117	244,875	407,046
Days Accounts Receivable	59	56	56	52	59	43	97

Source: Company financials, author's calculations

WTTR, however, is the glaring exception, with 97 days of receivables. Given its historical track record, the quality of its customer base, and the current robustness of the industry, I have no doubt that these receivables are all money good. (In 2017, WTTR wrote off just \$707k—a truly negligible amount—of its trade receivables.) There's just no reason this number should be so large.

What's wrong with having so many accounts receivable? The answer is that it unnecessarily uses up a lot of capital. By reducing its accounts receivable from 97 days to the 54-day median of the six companies above, the company would generate \$180 million in cash! That's more than the free cash flow the company is expected to generate in 2018 and, at current prices, that would be enough to buy back more than 13% of the company. As things are today, the company is just giving its customers a free ride on its cash balances.

Are there any structural reasons why management cannot reduce receivables from 97 to 54 days? Certainly, none that I can even imagine. This is the exact same customer base that the pressure pumpers and the frac sand providers sell to and if they can all do it, so can WTTR. I don't even think it would be that difficult. In fact, it's probably even the same person signing the check. Just like making the toothpaste hole larger, it is one of those simple ideas lying in plain sight that can have a profound effect on the value of the business.

Therefore, my very strong suggestion to management would be to commit to reducing, over the balance of the year, the company's days accounts receivable to the industry average of 54 days. Don't take the easy way out by stopping at 80 days or 70 days and making excuses why it cannot be reduced further. Work to get the receivables down to at least the industry average of 54 days. From the current base of accounts receivable, this will generate approximately \$180 million in cash. Assuming that quarterly revenues grow to \$450 million by Q4, the better accounts receivable discipline will generate an additional \$35 million in cash flow from operations in 2018.

Because the company is already generating meaningful free cash flow after capital expenses, it has no pressing need for this money. Therefore, given the value inherent in the shares and the company's negligible debt position, management should commit to using these funds to repurchase shares, starting immediately and proceeding at least commensurate with the cash generated by the reduction in accounts receivable. In fact, given the ease and surety which I expect the company to reduce its accounts receivable, as well as the attractive current price of the stock, any repurchase of shares should be immediate and front-end loaded.

CONCLUSION

WTTR is a unique company that has everything needed to become a great investment, including,

A low valuation. The shares trade at just 4.3x projected 2019 cash flows, cheaper than its pressure pumping and frac sand peers. Given the trends in the business, the opportunity for margin improvement, and the investment opportunities the company will no doubt have, I expect actual 2019 cash flows to be meaningfully greater than projections.

An attractive entry point. The shares have declined from \$22 to \$13 and, despite the tremendous growth in the company's revenues and EBITDA, the transformative acquisition of Rockwater, the vastly improved oil market fundamentals, and the rapidly quickening pace of completion activity nationwide, the shares currently languish below the company's IPO price from over a year ago.

Insider buying. CEO Holli Ladhani and director Alan Burnett recently purchased a combined 31,888 shares at slightly above current prices.

A strong balance sheet. The company has just \$68 million in net debt against almost \$1.1 billion in equity. According to management, the company will begin generating significant free cash flow right about now. The company will have a lot of options for its free cash flow and hopefully repurchasing stock will be one they will consider.

An important and increasingly complex niche. Water supply and management are a mission critical element of today's fracking process. Oil production doesn't happen without fracking and fracking

doesn't happen without billions of gallons of water. WTTR is the biggest and most important player by a wide margin.

A protected competitive environment. There are competitors, but none of them have anywhere the scale and scope of proprietary water and easement rights that the company has. As I said earlier, the proof is in the pudding. Despite the capital that has been invested in all things fracking related, there is still no competition notable enough to single out by name in the 10K.

Strong growth opportunities. Because of its size, the company can take on projects that no one else in the industry can. When it comes, the establishment of an in-ground pipeline system in the Permian Basin will cement their leadership position there.

Numerous catalysts for share outperformance. Second quarter earnings should be excellent. Second half earnings will be even better. Free cash flow is ramping and will continue to ramp sharply.

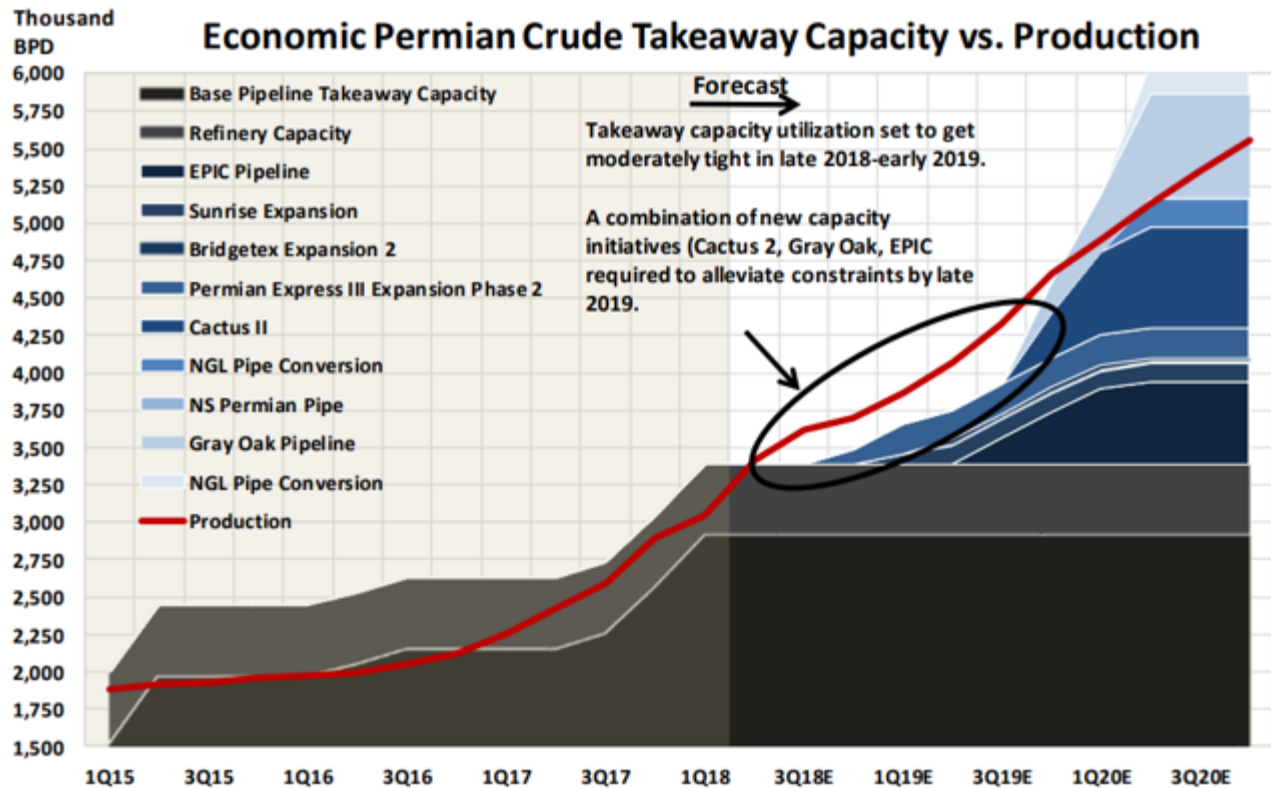
In sum, WTTR is an excellent way to participate in the continuing surge in U.S. crude oil production with the least amount of commodity exposure. At current prices, I expect it will be a substantially better investment, over pretty much any time period, than any of the pressure pumpers or frac sand producers.

For investors who own E&P companies and actually want the commodity exposure, WTTR will be a great investment as well.

ADDENDUM: PERMIAN DIFFERENTIALS

Over the last two weeks or so, WTTR has sold off from the \$17.50 level to the \$13.50 level. The proximate reason would seem to be **concerns over the potential for a slowdown in Permian oil production.**

Here's the issue. The Permian is an absolute hotbed of activity right now. What has happened is that Permian production growth has now exceeded the region's pipeline takeaway capacity. As shown below, while additional pipeline capacity is coming on imminently, the rapid growth in Permian production will still likely result in about 200,000 bpd of deficit in pipeline takeaway capacity for the next year or so.



Source: Raymond James research report

E&P producers who haven't reserved pipeline capacity in advance, are going to have to transport their oil to the coast by rail. If they can't do it by rail, then they will have to do it by truck. That's a lot more expensive and both rail and especially trucking capacities are limited. Either way, unless the E&P producer has hedged the basis differential (and apparently many of them have), it will have to eat the cost.

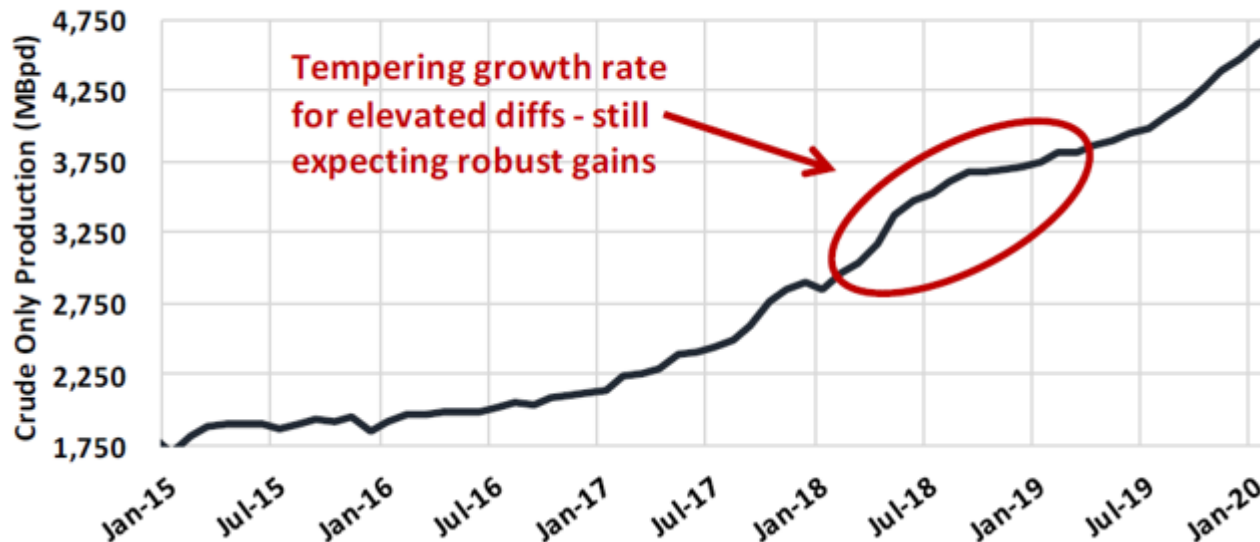
For sure, this is a temporary problem as significant new pipeline capacity is slated to come on in mid/late-2019. But what about the next 12 to 15 months? The question on investors' minds, and the reason for the selloff in WTT and other stocks with Permian exposure is the concern that this issue will force a slowdown in Permian drilling and fracking activity.

The conclusion, according to Raymond James, which has a terrific energy research team, is, "probably not in any meaningful way." It may, at the margins, slow the growth in Permian activity, but any such slowdown will be mild and transitory.

In the worst-case scenario, you will have excess production in the Permian of about 200,000 barrels per day for about 12-15 months. That's about 5-6% of current Permian production of 3.5 million bpd. Let's assume that about half that amount can make it to the coast by rail or truck. That means the real shortfall in takeaway capacity--the kind that may begin to slow activity--is only about 2-3%.

As a result, Raymond James has modestly tempered their Permian production forecast. As can be seen, the differences from their earlier forecast are hard to discern.

Updated Permian Production Forecast



Source: Raymond James research report

This issue was widely discussed on first quarter E&P conference calls and no company reported they were considering such a shut down. On their recent conference call, WTTR management also indicated that they had discussed this issue with their customers and none indicated any change in drilling plans. This should not be a surprise, because the major companies that WTTR deals with have undoubtedly all reserved sufficient takeaway capacity for the hundreds of thousands of barrels per day they intend to produce each day. It is the smaller private equity backed E&P's, with less sophisticated operations, that will most likely be impacted. Nonetheless, this modest reduction in their forecast is probably a prudent move.

So what does it mean for WTTR? The answer is basically nothing. The Permian is on fire and oil production will continue to grow rapidly. As I said earlier, it's the hottest drilling basin on the planet right now and it will stay that way for near future. Don't be fooled--you WANT a company Permian exposure.

In the worst case, you might have a 2-3% reduction from what volumes might have been had there been no takeaway constraints. That might lead to a corresponding or slightly greater moderation in activity. Since the Permian accounts for about one-third of WTTR's revenues, the nominal impact to the company might be on the order of a 1-3% reduction in revenues, which is nothing in the context of its strong growth. Furthermore, since WTTR operates nationally, they may very well be able to move their equipment and pick up offsetting business in other basins. Currently, they are still moving equipment into the Permian, so maybe that pace just moderates a bit.

Disclosure: I am/we are long WTTR, LBRT.

Weighing Machine, Contributor

Comments (1136) | + Follow

Great article on a Fascinating company. I see there is a very large \$400+ million minority interest and am wondering how you are incorporating this into EV?

09 Jun 2018, 12:01 AM Reply1Like



Author's reply »

I always appreciate it when people follow up and ask intelligent questions.

The so-called minority interest is really the class B shares which are convertible into regular class A shares.

So, technically, there are only 65mm or so shares after the minority interest. But since the minority interest can (and will) be converted into regular class A shares, **the appropriate share count is 106mm**, which effectively eliminates the minority interest. I may have the exact numbers wrong, but that is the concept.

Weighing Machine, Contributor

Comments (1136) | + Follow

I appreciate your prompt reply - thanks!

Though I'm a generalist and would consider oil services to be a relative weak spot for me, this investment seems to have a lot going for it:

- 1) leading position in an important industry
- 2) strong balance sheet (potentially even stronger if they can bring down A/R as you suggest) which should help them survive in downturns and continue to make acquisitions
- 3) very low valuation
- 4) industry tailwind with increased drilling/completions
- 5) possibility of being acquired

If we fast forward 18-30 months, and the stock was flat to down, other than the macro env/general stock market or lower oil/gas prices, what do you think the potential culprits would be?

09 Jun 2018, 11:45 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Other than the general macro, I can't think of anything. Of course, there's always something but I cannot think of it now.

As I suggested in the article, even if the sand and pumpers both build to oversupply, that will reduce the cost of fracking and therefore increase the amount of fracking. That scenario is good for WTTR.

Here's my other thought. In 30 months it will be 2020. I believe that oil prices could skyrocket by then.

What most people are missing in their analysis of oil is that **over the past 3-4 years the record of deferred FID's (final investment decisions to go ahead with an oil project) has fallen dramatically.**

According to Goldman Sachs, it is currently costing the world 2mmbpd in supply that would have been there. That's another reason spare capacity is so tight. By 2020, that number will increase to a deficit of 4-5mmbpd, which is huge.

Current spare capacity is on the order of 1.5mmbpd or so (no one knows for sure). If OPEC/Russia increase by 1mmbpd, then spare capacity declines to 0.5mmbpd. Add in demand growth of 1.5-2.0mmbpd annually and depletion of existing fields at 5-7mmbpd annually and you've got a real problem.

While there is a lot of investment in shale, the rest of the world is still way underinvesting. People who don't know the numbers think shale will cure everything but it won't. It's only a small fraction of global demand of 100mmbpd.

Comments (34) | + Follow

You talk about receivables as if wishing them lower would make them so. How do you think they should go about this? It doesn't seem to be a bad debt issue, just slow paying. Are they not sufficiently aggressive at collection? Should they cut off deliveries to past due accounts?

06 Jun 2018, 01:12 PM Reply0Like



tulip717

Comments (26) | + Follow

Looking at the holder list I am now wondering if it is in fact White Deer holding the stock back. Their holding in WTTR is in an older fund (vintage 2010) and one of the only positions left to be sold. I wonder if the market senses this overhang? Because the reasons why this stock lingers down here are few and far between.

08 Jun 2018, 10:37 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

First, I don't know what happens at other companies. Second, it is one those areas where you can be proactive.

According to the company, the issue is they get a late start on billing. They do not bill until about 20-30 days after service has been rendered. Obviously, they could bill earlier and that would be pretty easy. It's also easy to see how that could have slipped a bit during the merger process.

In the A/R business, I think just moral suasion goes a long way. Hey, we would really appreciate if you paid on a timelier basis. I mean, I'm not making this assertion in a vacuum. Whatever it is that all these other companies are doing, they are getting an average of 54 days A/R which is what I would have expected.

08 Jun 2018, 10:47 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Tulip, that is exactly what I concluded as well. Don't know if it is true. Don't know if you saw, but FRAC recently announced that had completed \$34mm of its \$100mm share repurchase authorization. Of the \$34mm, \$20mm was purchased from White Deer. FRAC is held in their White Deer II fund.

So, that is my best guess as well. I think they own about 4 million shares and I would not be surprised if they were mostly done by now. The shares have gone from trading 400-500k to trading 900-1,000k. Yesterday, it traded 1.6mm shares. So, the stock is getting absorbed.

I don't think it takes much to sense this overhang. There's a lot of stock for sale, it's weighing on the market, and when it is done, I think the shares will pop quickly.

Given the large volumes recently, I would be surprised if there were that much left. Plus, if there is real institutional interest, those shares could be gone in a flash.

Also, if White Deer were selling, they would not have to file.

08 Jun 2018, 10:52 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

BTW, the White Deer I fund which owns WTTR also owned OTEX. OTEX was sold late last year to CJ so I would not be surprised if those shares were being liquidated as well.

The story about enlarging the toothpaste tube hole reminded me of a similar story. How to double the sales of shampoo by adding one word to the label.... "Lather, rinse." changed to "Lather, rinse, repeat."

P&G made the size of the scoop included in a box of Tide detergent larger. There are marks on the side for small, medium, large loads, but many will just use a scoopful no matter what.

06 Jun 2018, 09:35 AM Reply3Like



Duke802

Comments (1615) | + Follow

low inside ownership and institutional owners sold off in Feb, - looks risky

06 Jun 2018, 09:41 AM Reply0Like

Mintwood, Contributor

Comments (60) | + Follow

Thank you Mr. Bert. This is excellent research by someone who also has a deep understanding of the institutional investor mindset and process.

It seems Select would make for an excellent acquisition candidate, as stated above, for any number of industry participants - integrated, E&P, service, etc., due to the extraordinary competitive advantage. However, their position is so strong I wonder if there could be antitrust issues?

I, personally, am generally against share repurchases, unless a stock is below book value. This is a long debatable issue, obviously. In the case of WTTR, the company's advisors and bankers may say it would be in poor form to repurchase shares so soon after the IPO. I do agree with the receivables issue - the must be hundreds of billions of cash uselessly tied up in receivables and inventory across the business spectrum.

One editorial comment: You cite Gregory Rockhouse Ranch as a private company but someone has entered (NYSE:GRR). Just FYI.

06 Jun 2018, 10:32 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

There would be no antitrust issues whatsoever. It is still quite a fragmented industry. The fragmentation is a great opportunity to buy up the smaller operators at very attractive price and fold them into their

business. Great way to add customers accretively. If you look at the presentation, they've made quite a number of smaller acquisitions over just the past year.

Yes, thank you. To be clear, GRR = Gregory Rockhouse Ranch, a private company and not whatever ticker it is.

WTTR is its own business. It would not make sense for an E&P to buy it. It makes all the sense in the world for a pressure pumper to buy, but Halliburton is the largest and could best make use of their national footprint. They also sell for the biggest multiple and could easily write the biggest check.

06 Jun 2018, 10:46 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Now that SLB is back in the pressure pumping business, it would also make a lot of sense for them as well. They are a bit behind so this would be a great way to get in the door.

06 Jun 2018, 10:47 AM Reply3Like



Mintwood, Contributor

Comments (60) | + Follow

Again, excellent work. My compliments.

06 Jun 2018, 10:51 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

bigredanalyst, I couldn't agree more. It is way premature. There are too many opportunities to build and grow the company. WTTR can also be a very a successful company on its own and has absolutely no need to sell. If I were WTTR, I would not be thinking of selling. If I were HAL, I would be scheming to find a way to buy.

06 Jun 2018, 10:56 AM Reply3Like



Darp

Comments (3897) | + Follow

Chez sent me this way. Growth in last few Qs is rather amazing, think will take position, but being have just read first 2 pages of this and then went to Qs, will study more. Thanks for the article.

Are there any oil geologists here? I found a report from Corridor yesterday that appears to accidentally got on web. It is a proposal from Corridor (CDDRF) to big oil company to partner with them on Old Harry, the largest Canada east coast 4 way undrilled structure. They are talking 4 to 20 Billion barrels of light oil.

They have done a CSEM study on it. The report is quite technical, hope someone here can understand it. I am a geologist but not oil geologist. So not sure about certain parts of it. here is the link www.pesgb.org.uk/...

Anyone here understand it?

Also found this letter on gov site, where Corridor want to drill Old Harry by late 2018 www.cnlopb.ca/... So logically the CSEN study was good. I was hoping for 1-2 billion, but the structure is massive and thickness much better than hoped for, so they say if one formation 4 billion if the other 20 billion barrels.

If you can understand it please post here seekingalpha.com/... Current mkt cap about \$60 million and loaded with cash, and has broken out on chart, which caused me to search web for news.

06 Jun 2018, 10:38 AM Reply2Like



Dave.G

Comments (80) | + Follow

The author over-simplified the Sand market. It appears to be a commodity, but is fraught with complexity: regulatory and permitting issues, environmental issues, mesh size and local scarcity, and logistics (both local trucking and rail). A lot of the new players in the space will have no significant impact on the market all while demand climbs....

Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

And how does that contradict anything that I have said?

08 Jun 2018, 09:01 PM Reply0Like

Mintwood, Contributor

Comments (60) | + Follow

Does the merger have anything to do with the jump in receivable days? Rockwater pumping sales with extended terms for song and dance prior to the acquisition?

06 Jun 2018, 11:46 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Mintwood, yes, absolutely. I spoke to the company and they are aware of the issue and plan to bring A/R down. I'm just not sure they are targeting 54 days like they should be. I got the sense they were targeting 80 days, at which point they would declare victory and go home. I also did not get the sense they knew how much above the industry average they were. Maybe this will spur them to greater action. Certainly, if I were Crestview, I would be all over them on this. It's just too easy a way to create value.

In response to your second point, I really doubt Rockwater was pumping sales prior to the merger. They were a private company after all. I think it was just an issue that got slightly overlooked in the transition.

06 Jun 2018, 11:59 AM Reply4Like



Comments (80) | + Follow

In regards to reducing DSO, every oil services company focuses on that. Basic fiscal responsibility of the CFO. It's controlled by the payment cycle and willingness of the oil companies to pay. None of the oil companies are good at paying on time. They dispute most of the invoices just to slow down payment. WTTR has the same struggle as every other oil services company and is well aware of the cash flow implications....they just can't control it. The oil company has the leverage, not the oil service company

06 Jun 2018, 11:14 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

This is business. Oil companies do not "dispute most of the invoices just to slow down payment."

The point was that WTTR is well below the industry norm in terms of A/R management. It would have to be pretty straightforward for them to at least get to the industry average.

06 Jun 2018, 11:21 AM Reply1Like



Dave.G

Comments (80) | + Follow

I worked for an oil services company. Don't fool yourself or anybody else that oil company's don't use disputes as a common tactic to slow down payments. They do, all the time the last 4 years. As you said, it's business!

06 Jun 2018, 11:56 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Well said, but in all fairness, if you are well-versed in the industry (as many of these commenters seem to be) the logic of a buyout by Halliburton is actually a pretty logical question. I've got to think that these guys could sell themselves to HAL at a pretty generous premium any day they want.

06 Jun 2018, 11:44 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

chezjonz, I could not agree more. Of course, if HAL offered \$32, I would have to seriously rethink the matter. With WTTR selling at 4x and HAL selling at 12x they have a lot of flexibility in price.

06 Jun 2018, 12:00 PM Reply0Like



Dave.G

Comments (80) | + Follow

I do agree that over time, sand will again take on its core commodity attributes in the marketplace. Probably 2 years until that happens

06 Jun 2018, 12:01 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Agreed. Sand prices will stay elevated for a while. That said, there's been a flurry of capacity announcements this week. Now they are opening up in-basin mines in the SCOOP/STACK. It will be interesting to see how sand stocks play out. They are cheap, I have to admit. So there is upside.

06 Jun 2018, 12:08 PM Reply0Like



Dave.G

Comments (80) | + Follow

I appreciate your well written article and research on WTTR

06 Jun 2018, 12:02 PM Reply1Like



chezjonz

Comments (948) | + Follow

if if if a frog had wings it wouldnt bang his ass every time he hopped. close my eyes. if permian keeps deteriorating and there are shut ins and lower capex for 3-6 months this might see low 12s and ill add. otherwise ill open my eyes when this tries too go through 15

06 Jun 2018, 12:04 PM Reply1Like



Ocean Viewer

Comments (12) | + Follow

Well-presented positive argument for WTTR. Seems to make water sources and rights almost as valuable as oil. Picked-up a few shares for cap gain speculation, as am only a dgi investor.

As an aside, see you don't take yourself too seriously (Bio), and SA production very limited/sporadic. Assume you are an older retiree like myself who enjoys the occasional written adventure. Thanks for the time-relevant information.

06 Jun 2018, 12:15 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Thank you. Yes, I do not write a lot. Only when I think I have something terrific that is being entirely overlooked by the market. I'm not in this to collect fees from Seeking Alpha. I could have published it as a Top Idea for \$1,000, but decided I would rather share it in a timely manner with the community.

My two previous recommendations have performed just as I expected. Occam Networks was a five-bagger (including \$2.36 of litigation proceeds). Mammoth Energy (a sand/pressure pumping company) more than doubled in eight months.

06 Jun 2018, 12:22 PM Reply13Like



Ed.N

Comments (18) | + Follow

Mr. Bert: Another great analysis from you.

I am sure this took a lot of "Homework" on your part. THANKS !

I am in WTTT now and waiting for the turn around in price of Oil. But this article makes me sleep better at night. And will add more.

06 Jun 2018, 12:24 PM Reply0Like



Manoj Madhavan, Contributor

Comments (390) | + Follow

Mr. Bert - what an excellent piece of research! You have made my day!! I am drooling with anticipation over your next piece.

Question- you talked of takeaway constraints in the Permian tempering production in the short to medium term. What about water access rights and environmental issues - as it relates to water? Do you anticipate negative press about excessive depletion of water resources and concerns about

groundwater contamination hampering the ability of WTTR and other water companies to secure new sources to supply the expected growth in water demand?

06 Jun 2018, 12:30 PM Reply4Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Good question. As I said in the article, I think this will be a big story in 2018 and going forward. As I'm sure you know, fracking has its detractors from an environmental perspective. Obviously, depletion of the water supply will be one of those issues that gets caught up in this whole thing.

I think all of this will be just noise. The benefits of shale production from a national economic and security perspective are just too important. Places like West Texas, where water demands are greatest, are also making an absolute fortune from the whole fracking infrastructure.

Also, I do believe that water will get scarcer. By that I mean it will get more expensive and that will be good for WTTR. In the end, there will be enough water for most of West Texas because it sits over a number of fairly meaningful aquifers.

The companies will have to be sensitive to environmental concerns and I expect the recycling of post-frac water to be used again as pre-frac water will be a significant growth driver.

06 Jun 2018, 12:35 PM Reply1Like



User 15924502

Comments (34) | + Follow

Scrubbing and recycling is another opportunity.

06 Jun 2018, 01:20 PM Reply0Like



Ocean Viewer

Comments (12) | + Follow

Thanks for background info. See you no longer hold (disclosure) OCWN nor TUSK. But what about LBRT? See no previous write-up. What do you expect from Liberty?

06 Jun 2018, 12:42 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

OCNW was acquired in 2010-11 for \$9.23/share. I then led one of the most successful shareholder class action litigations ever, which produced an additional \$2.36 per share in litigation damages. (Would love to write a book about it.) Final total proceeds of \$11.59 or so. Most of the filings are public if you are really interested. It was a legendary battle in the Court of Chancery with many many twists and turns.

I do own LBRT, but I own a lot more WTTR. Would much prefer to own WTTR.

I sold TUSK but they have really performed phenomenally. I liken WTTR at its current price to TUSK when I recommended it 8 months ago at \$17. It's now \$38.

06 Jun 2018, 12:45 PM Reply6Like



Dave.G

Comments (80) | + Follow

Agree that the post-frac water being treated to be reused as pre-frac water is a growing trend nationally, and makes even more sense in West Texas where water is scarce...

06 Jun 2018, 12:45 PM Reply3Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Here's my question, and maybe you know the answer. Is water in West Texas really scarce or it just pseudo-scarce? It's hard to believe that recycling would be cheaper than just going to the well. I understand that from a corporate citizenship perspective it makes sense. I can see how if you are fracking multiple wells it may make sense to use post-frac water from one well and recycle it into pre-frac water for another well, but it's not entirely obvious either.

06 Jun 2018, 12:52 PM Reply0Like



Ocean Viewer

Comments (12) | + Follow

And is there another "big" overlooked story in recycling all the surface-borne injected water/wastewater? Got to be big business for somebody, or are Mammoth or Occam in that business (didn't read material yet)?

06 Jun 2018, 12:52 PM Reply2Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Occam is most certainly not in that business. They make telecommunications equipment. LOL. Mammoth is not in that business either.

Here's the deal. A vertical well produces about 10-15 barrels of water for each barrel of oil, but the water can be and is reinjected to the well for enhanced oil and recovery, so it has a natural home. A horizontal well produces about 4 barrels of water for each barrel of oil, but there is nowhere to reinject it. At 4 mmbpd of Permian production, that's 16 mmbpd of water per day or 6 billion bbls of water per year that must be disposed of or recycled.

It will be a big story as well. WTTR does that too, but there focus is on pre-frac water. They say it is less competitive.

06 Jun 2018, 12:59 PM Reply3Like



PDE (Petro_Drlg_Engineer)

Comments (299) | + Follow

Depending upon the area, there are other options for produced water disposal from horizontal producing wells. Was a engineer for Burlington Resources in early 1990s in Midland, Texas. We unitized the Tobe Foster field with Texaco to do a full-field waterflood. Main problem was reservoir was isolated so no active water drive from the bottom for pressure support. The only available water for waterflood, to replace oil, increase the reservoir pressure and push the oil to the producing wells, was fresh water. Therefore water from horizontal producers could be used to support offset conventional producing fields. Operators have to do compatibility testing on the produced water, remove as much oxygen as possible, but produced water from horizontal wells could be used in this specific situation for waterflooding conventional wells.

Another competitor to these companies is the oil companies themselves. One of my most economic projects in West Texas was converting a shut-in well to a water disposal well. This reduced the LOE (Lease Operating Expenses), and we went from hiring trucks to haul and dispose of the water, to simply laying a polyline and installing some surface equipment at the newly converted WDW (Water Disposal

Well). So if there is sufficient volume, the oil companies will work to reduce outside expenses by doing as much as they can themselves.

Hence my paradigm is that TPL is a better investment as they get most of their revenue from Oil and Gas Royalties, then hopefully lots for the water business, easements, etc.

07 Jun 2018, 06:11 AM Reply2Like



StayRational

Comments (1653) | + Follow

Intriguing piece and the company type is certainly out of my wheelhouse. Though, my instinct tells me to dig into your article and research more (which is a good thing as my last 2 learning/digging companies were TK and UNIT - which are both doing extremely well for me).

I appreciate you opening my eyes to another potential opportunity.

06 Jun 2018, 12:54 PM Reply1Like



Ixthus72005

Comments (7) | + Follow

Great research. Lots of granularity for the serious investor. I want to push back a bit on the "pristine balance sheet" observation. Since WTTR has no serious comparable in the sector, and you point out it is not to be viewed as a commodity play, how does only \$6 million in cash and \$75 million in debt result in a "pristine balance sheet"?

06 Jun 2018, 01:01 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Ixthus,

Basically \$68mm in net debt against \$1.1 billion in stockholders' equity and \$60mm in Q1 EBITDA with FCF ramping and \$180mm that can be squeezed out of A/R.

I guess it is just semantics. I view it as a pristine because I think the optimal balance sheet would actually include some debt. This is not a technology company and there is no need to have a lot of net cash. So, I would consider it pristine but it is not a fortress.

WTTR has in the past said that their target debt level could be as much as 1-1.5x annual EBITDA. They could easily support \$250mm or more in debt should they want to.

06 Jun 2018, 01:06 PM Reply0Like



User 15924502

Comments (34) | + Follow

Key takeaways:

1. Not a commodity business but being priced like one.
2. Near monopoly position.
3. High barrier to entry.
4. Increasing demand.

Without any change to the business, the stock could double simply based on a more realistic valuation. Then there is the likelihood of growth.

Wow.

06 Jun 2018, 01:06 PM Reply5Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Not sure it is fair to say there is a *near monopoly position*. There is competition, to be sure, but it is fragmented and local.

What's exciting is the fact they can increase the lead over the competition by building an in-ground pipeline infrastructure in the Permian.

06 Jun 2018, 01:08 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

HERE'S A TRULY FASCINATING ARTICLE.

www.nytimes.com/...

This shows what the Bakken underground pipeline system would look like if it were above ground.

06 Jun 2018, 01:09 PM Reply2Like



PDE (Petro_Drlg_Engineer)

Comments (299) | + Follow

LOL... Interesting work, but unsure of the terminology of 'oil drilling line', when it's simply the oil wellbore! ;-) They appear to have only looked at the casing strings for wells, and not any gathering lines near the surface to connect wells to tank batteries, or pipeline systems. That's a whole other tangled web that's rapidly expanding when one considers gas - oil - water!

Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

OPEC, Permian takeaway worries is my guess. Both essentially non-events.

06 Jun 2018, 02:06 PM Reply2Like



baytracker

Comments (5) | + Follow

Well laid out research Mr. Bert. I am long LBRT, PUMP, PTEN and SND. Also, long big oil CVX and COP. Had not thought much about the water part of the fracking puzzle even though my son has been operating a water drilling rig, almost without a break, in west Tx. I will take a hard look at WTTR. Appears to be an excellent long opportunity especially after the recent pullback.

Mr. Bert,

Thanks for the article. Any thoughts on the effect of the 50,000,000 mixed shelf offering? It seems to me that with this many shares in the hands of investors that may want to liquidate that the share price would be unlikely to move significantly higher as there is likely to be more supply than demand for shares for the foreseeable future.

Would be interested in both the author's and any other's thoughts on this.

06 Jun 2018, 02:10 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

I think these things are pretty routine.

While WTTR itself can issue shares under the shelf, it has no need for the money so that is a non-event.

The rest of the shelf is for the big private equity backers. They can't really dribble stock into the open market. If they were to sell, they would do an underwritten offering. I highly doubt they are sellers at these prices.

It does feel there is some sort of meaningful seller who has been around for a week or so. Not sure who or why or how much, but I suspect that when he is done the shares will pop back into the \$17-18 range. The seller has been weighing on the stock, but the stock is now trading very good volume and eventually the seller will be done. Hopefully some funds will come in and buy some shares and hasten that process. Shares have been trading good volume so if there is a seller, he's getting taken out.

06 Jun 2018, 02:16 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

I suspect that WTTR is a customer of TPL's. My fondest dream is that, as the largest player in the Permian, they have cut an exclusive deal for some of TPL's water and easement rights. That would have me choking the chicken at night on a regular basis.

I suspect that WTTR also has other water rights in the Permian and so that may make them somewhat of a competitor of TPL's as well.

The problem with TPL is that they release so little information, we really don't know exactly what they do. They claim they are going to be a full-service water company, but what does that mean? They claim they are going to be in the recycling business, but what does that mean?

06 Jun 2018, 04:29 PM Reply1Like



Krypto

Comments (4125) | Following

Mr. Bert: I've owned shares in TPL since 2012, and bought the bulk of my holdings in 2013. I've read every piece of information about the company I could get my hands on since then.

Going back to 1888, they have never provided any more information than they had to provide. While not ideal from my point of view, in respect to wanting information, the other side of the coin is that everyone seems to get the same publicly available information, and insiders do not seem to get the leaks on earnings prior to announcements, which seems like TPL is a very ethical operation to me. (Not that you or anyone else has implied otherwise, all due respect) Most companies leak that very valuable information and the stocks respond the days prior to announcements, but not with TPL.

They have treated their subshare certificate holders very well over the years, but I suspect they will never give out any substantial information beyond minimum SEC reporting requirements. I'm grateful SeekingAlpha is here to ferret out more information on the company.

I am going to buy some WTTR (based upon this article that I highly recommend to any serious investor - so that obviously disqualifies Tesla "investors") **and I too hope TPL sells them lots of water and easement rights - hundreds of million of dollars worth would please me immensely.**

07 Jun 2018, 09:12 PM Reply1Like



HunterKiller89

Comments (854) | + Follow

I wish you wrote more Bert. You always have such comprehensive and compelling articles on some truly undervalued companies. You my good sir know how to find the diamonds in the rough!
Many thanks, for this article and past success /w TUSK

06 Jun 2018, 05:10 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Thank you. As I am sure you understand, quantity and quality are often inversely related.

06 Jun 2018, 05:26 PM Reply5Like



HunterKiller89

Comments (854) | + Follow

I'll take quality over quantity any day. I suppose I'm getting greedy :P

06 Jun 2018, 06:19 PM Reply0Like



beausefus

Comments (9) | + Follow

Very impressive! I have lobbied you multiple times on other threads to write such an article and boy did you deliver. My favorite part is your quote above. A tpl - wttr deal would have you choking the chicken on a regular basis. haaa

cheers

06 Jun 2018, 08:23 PM Reply1Like



dclonghorn

Comments (91) | + Follow

Thanks for the wonderfully written and researched article.

06 Jun 2018, 05:29 PM Reply3Like



OrangeClown

Comments (273) | + Follow

WOW! Thanks for the great write up!

06 Jun 2018, 05:30 PM Reply1Like



amalfit

Comments (125) | + Follow

Exceptionally well written and thorough analysis Bert - thanks for putting this on our radar.

06 Jun 2018, 06:17 PM Reply2Like



Manoj Madhavan, Contributor

Comments (390) | + Follow

Nobody knows how the market will turn out in 2019. Based on 2018 numbers, WTTR is not so cheap.

WTTR is trading at 8.74X when you use Q1 2018 numbers.

Ticker "Market Cap

(in millions)" "Q12018 EBITDA

(in millions)" (Market Cap)/(2018 EBITDA)

EMES 238 17 3.5

HCLP 1140 64 4.45

SLCA 2356 95 6.2

SND 243 6 10.1

WTTR 2063 59 8.74

06 Jun 2018, 06:27 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

I am disappointed in your comment because it means you have basically missed the whole point of what I was trying to say. The whole point of my article is that sand doesn't merit a large multiple because the earnings are cyclically elevated and there is a mad rush to increase supply. Those earnings could collapse.

Also, you should not use Market Cap / EBITDA as it does not take into account the capital structure. You should use EV/EBITDA which normalizes for capital structure. That is why EMES looks cheap. They have a lot of debt.

06 Jun 2018, 06:35 PM Reply9Like



Manoj Madhavan, Contributor

Comments (390) | + Follow

I agree - EV/EBITDA is a much better measure. By that same token, while looking at the 2019 predicted EBITDA and calculating the multiple, one should also look at the multiple based on annualizing current quarter run rate for EBITDA. This is where Q1 2018 - actual numbers, not projected ones - comes into the picture.

One more thing - your point about EMES and other sand companies is that supply will quickly rise up to meet demand and this will cause realized prices to drop rapidly causing all EBITDA projections by company management to look foolish. I counter that, while this may turn out to be true in 2019 or beyond, companies like EMES will have a whole different capital structure if they manage to reach \$120M in 2018 EBITDA as they have repeatedly guided on calls.

06 Jun 2018, 10:26 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Yes. that's true. If they do earn that and they use the proceeds to pay down debt, they will have a much better capital structure. So far, they seem to be using it for more supply expansion (surprise).

Also, if my memory serves me, prior to the December quarter they were quite confidently projecting to something like \$160mm EBITDA for 2018 and then somehow that suddenly came down to \$120mm. Don't follow the company closely enough to know why, but I suspect that's the kind of thing that can happen in that type of business.

That said, the companies are cheap.

07 Jun 2018, 03:45 AM Reply3Like



igor555

Comments (1847) | + Follow

nice piece Mr Bert!

i remember many years ago t boone was buying up water parcels in texas and folks were questioning his sanity.

that guy is a genius.

06 Jun 2018, 07:41 PM Reply1Like



RS055

Comments (7072) | + Follow

Fabulous piece of research!

Now, SA might consider getting their Market Cap and lil stuff like that right. Oh - and the dividends - better double check with Yahoo before trusting any dividend yields on SA.

06 Jun 2018, 07:56 PM Reply0Like



thetravelacct

Comments (12) | + Follow

Great research! You earned a new follower for whatever that is worth

06 Jun 2018, 10:57 PM Reply0Like



thorgood4

Comments (2398) | + Follow

wowzer! a new follower here too...it will take a couple of readings for me to get onboard ,,cheers

06 Jun 2018, 11:11 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

CORRECTION:

In the text of the article, I state that the company has annual water rights of 1.5 billion gallons of annual water rights. I then quote from the 10K, which states that the company has annual water rights of 1.5 billion barrels. The 10K is, of course, correct. Note that the Rystad chart showing demand 2017 demand for water is expressed in billions of gallons.

1 barrel = 42 gallons, so with more than 60 billion gallons of annual water rights, the company has a very significant portion of annual demand covered.

07 Jun 2018, 05:13 AM Reply2Like



PDE (Petro_Drlg_Engineer)

Comments (299) | + Follow

There are also various manufacturers, but the picture of "lay-flat hose" appears to me to be a polypipe! Have seen others that "lay-flat" but they are usually brown and covered in canvas or similar material.

Maybe the polypipes have gotten better over the years like PEC plumbing for houses, that expands so it will not burst if water freezes and expands during the winter.

07 Jun 2018, 08:22 AM Reply2Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

You are correct. Both are used. This is layflat hose.

www.google.com/...

07 Jun 2018, 09:04 AM Reply0Like



bud.grieves@gmail.com

Comments (6) | + Follow

Well done and thank you for all the time and effort you obviously put into this report. I would however take exception to your assumption that all frac sand suppliers will collapse due to new capacity coming on stream. Environmental issues, labor shortages, and supply logistics will increasingly favor large established players like HCLP and SLCA as the industry consolidates. Drillers are signing long term contracts to assure adequate long term supplies with the largest most reliable suppliers. When Mr. market realizes this multiple expansion sure to occur. Meantime earn 6% div on HCLP. Long HCLP and now WWTR

07 Jun 2018, 11:00 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Hold on... I never said they would all collapse from this point. The fact is they have collapsed and they are cheap. I like HCLP because of the dividend and the repurchase.

EMES, on the other hand, has a lot of debt and just announced in-basin mines in the mid-con.

I think HCLP has the right idea. You want to milk this business rather than continually reinvesting. The time to expand is when all the other companies with too much debt get into trouble when the cycle turns.

What bothers me most is that there are so many new companies, as I mentioned in the article.

07 Jun 2018, 11:25 AM Reply1Like



biomedlives2

Comments (125) | + Follow

I note that the analysts surveyed by Yahoo Finance don't do a very good job of estimating quarterly earnings for WTTR.

07 Jun 2018, 11:12 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Not sure what you are talking about. Why do you say that? Are estimates off the mark?

07 Jun 2018, 11:26 AM Reply0Like



beausefus

Comments (9) | + Follow

zacks has estimates of:

this qtr - .20

next qtr - .28

this year - .87

next year - 1.46

07 Jun 2018, 11:56 AM Reply1Like



metal27

Comments (922) | + Follow

Outstanding depth of analysis and presentation--what a pleasant change!

Can you comment on sponsorship and management quality/experience? M* shows a recent purchase of 16M shares by L.E. Simmons & Assoc.? And I see Holli Ladhani comes from Rockwater rather than WTTR.

07 Jun 2018, 11:56 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Sponsorship is Crestview. You can check out their website yourself. Lots of ex-Goldman big shots from what I can tell. LE Simmons is a private equity player as well who is very savvy in energy. I believe his brother is the late Matt Simmons who founded Simmons & Co. (later acquired by Piper or someone like that). He was very very smart as well.

The name Crestview probably comes from Crestview Lane which, coincidentally, is a street where Mr. Bert lives. It is one of the nicest streets. Never seen it, since it is behind a gate and on the water. I suspect they are all pretty savvy.

07 Jun 2018, 12:07 PM Reply1Like



Austin Newsom, Contributor

Comments (219) | + Follow

Thanks for the article. It's one of the best I've seen on this site in some time. A couple of questions:

- 1) Do any of the larger E&Ps source water in-house?
- 2) Management mentioned on the Q1 call that "the range within our margins from one region to another is relatively tight." This is exactly the opposite of what one would expect if this business really had pricing power. What do you think explains this dynamic?
- 3) Has management expressed any plans to exit the Wellsite Services segment? As you hint at, it seems like a distraction from their core business.

Any thoughts would be much appreciated.

07 Jun 2018, 12:44 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Thanks. In answer to your questions,

1.) Yes, I believe so. For example, in Q4 margins were lighter because a large E&P had maxed out its budget for the year. So, they replaced that customer with another customer but this new one had its own water sourcing, so margins were hit. The company has said that even those customers who have their own sourcing are good customers because they need the transfer, handling and everything else. But it would seem that a better customer would be one who needs the sourcing as well.

2.) Interesting question. I've thought about that as well. Note that while I said that WTTR did not have any national competitors, that I did not say it did not have competition. There is always local competition. Management has basically said they are raising prices but the H1 price rises will really be just to stay abreast of rising wages and costs. They suggest that in H2 they will get net margin improvement. They have suggested that incremental margins should be at least 35-40% and hinted they could even approach 50% I believe. It's on one of the CC's.

3.) No that I am aware. Given the current environment, it's got to be a profitable business and shouldn't be that hard to sell to someone. On the other hand, it probably also provides nice cash flow and it's not like they need the cash.

07 Jun 2018, 12:52 PM Reply1Like



igor555

Comments (1847) | + Follow

few years back owned FOSI (frontier) i guess i was too soon lol

anyways, with OCF < capex how are they funding the difference?

07 Jun 2018, 12:46 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

? OCF > capex.

07 Jun 2018, 01:03 PM Reply1Like



StayRational

Comments (1653) | + Follow

I'd guess operating cash flow

07 Jun 2018, 01:47 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

For Q1 they had \$35mm of OCF which more than financed capex of \$32mm or so.

The difference between EBITDA and OCF was mostly the build in A/R.

07 Jun 2018, 01:58 PM Reply2Like



igor555

Comments (1847) | + Follow

last 12M TTM they had

OCF: 40.2

CAPEX: 113.2

according to BBerg

07 Jun 2018, 02:18 PM Reply0Like



moonlightmile

Comments (30) | + Follow

Big volume and nice price movement

You got their attention Mr Bert

Very convincing article!

07 Jun 2018, 02:01 PM Reply3Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Yes... volume was 350k and next think I noticed it was 700k. It is now 1.2mm almost. Seeing some blocks and clearly an institutional buyer in town. Still feels like there is a seller but it looks like he is starting to sell stock very quickly. Once he is done, stock could really pop.

07 Jun 2018, 02:03 PM Reply3Like



Darp

Comments (3897) | + Follow

Well Bert you wrote a great article, I looked at chart and looked like a perfect time to buy:

Darp

Comments (3840) | + Follow

Got about 800 equiv thru options today, the chart looks great here, like a bottom. back to \$14. Already ahead :-)

Cheers

06 Jun 2018, 03:26 PM

And a day later its up 10%. We need to partner on some more stocks, just followed you.

07 Jun 2018, 04:27 PM Reply3Like



User 6265381

Comments (18) | + Follow

Hi Mr. Bert,

Great article. I agree that a lot of value is in the permits/easements, etc. How much of a risk is there that local municipalities and landowners sell access to water and transport to more companies.to capitalize on the increasing need for water? Obviously, exclusivity in access eliminates this risk and you mentioned some examples. Regardless, this company seems extremely well positioned.

Thanks for sharing

07 Jun 2018, 05:00 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

To be clear, WTTR is in a highly advantaged position competitively, but they are not a monopoly. Access/easement rights can be exclusive or non-exclusive. My assumption is that unless WTTR has

scored some sort of coup de grace, most of their Permian water rights are non-exclusive. It's a great question really because if I were WTTR I would try to be tying up exclusive water rights. They can promise the volume and cut deals that others cannot.

That's why I am excited about the prospect of their building their own pipeline system. It's a whole lot cheaper to transport water via pipeline to select points and then do the last portion of the run by hose.

Also, as WTTR said on their latest CC, water logistics and requirements are becoming ever more complex. It is one thing to be able to prove 25 million for one well, and another entirely to be the go-to provider who can come up with the hundreds of millions of barrels you may need for multiple projects, pad drilling, etc.

07 Jun 2018, 05:49 PM Reply1Like



User 6265381

Comments (18) | + Follow

Thank you very much.

I got out of TUSK (got in due to your article) after their subcontractor caused another blackout - oops. Since your article is now paywalled, would you mind sharing if the reason for your exit was due to valuation, better opportunities such as WTTR and TPL, or something else. If not, no big deal and thanks again.

07 Jun 2018, 06:07 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

I felt that TUSK was fully valued in the low \$30's when the rest of the energy stocks were at their lows. Without Puerto Rico, I think TUSK would have been selling at \$15-17 maybe. That gave a lot of valuation to Puerto Rico. That said, I would not be surprised if TUSK ends the year at \$60.

There was a time when TUSK was \$17 and WTTR was \$17. Then, there came a time when TUSK was \$30 and WTTR was \$13. The spread has actually increased, but I like WTTR better by quite a lot.

07 Jun 2018, 06:15 PM Reply2Like



46968416

Comments (54) | + Follow

what do you know about Layne water

07 Jun 2018, 07:40 PM Reply0Like



Krypto

Comments (4125) | Following

I'm going to initiate a position. Excellent article.

Could you estimate the intangible value of their completed water pipeline system in the Bakken?

07 Jun 2018, 09:05 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

No, and I really would not disaggregate it that way either. I would view the company as a whole and give it a multiple of either earnings or EBITDA. Adding on additional value for any pipeline system would be double counting.

07 Jun 2018, 10:02 PM Reply0Like



Krypto

Comments (4125) | Following

Mr. B: I'm counting it as an intangible asset, additive to the value of the rest of their infrastructure, much like goodwill.

I like the knockdown value to be significant, in the event they don't make enough profit.

Truly strange how they do not have enough leverage to lower the receivables delay, too.

07 Jun 2018, 11:18 PM Reply0Like



Jeremy Repede, Contributor

Comments (20) | + Follow

Mr Bert- Do you know how much capacity they are actually using of the 1.5 billion barrels that is possible? I am still in TUSK. I have tendency to agree with your thought that it will be a \$60 stock by the end of the year.

07 Jun 2018, 09:54 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

No, and I'm not sure that is an entirely relevant metric either.

07 Jun 2018, 09:59 PM Reply0Like



LeeFarnam, Contributor **EXCELLENT QUESTION**

Comments (56) | + Follow

According to the North Dakota State Water Commission Lake Sakakawea's total industrial water usage in 2017 was 26,572 acre feet in 2017.

Select Energy Services' two industrial permits are for a mere 1950 acre feet and 4900 acre feet, respectively, or just under 26% of total industrial water usage from Lake Sakakawea in 2017. (Edited)

Tetra Technologies, probably one of their biggest competitors in the basin, had an application for a whopping 12,000 acre feet of water but this application was voided (not denied, so unsure what implications voided means) and there are currently applications for XX,000s of additional acre feet of industrial water usage outstanding, perhaps on rough count up to 50% in additional capacity from the basin, none of which are from Select.

What does this say to your wide moat argument? If the (figurative) moat is only 26% filled by the company's own water, is it really that valuable and defensible?

07 Jun 2018, 10:47 PM Reply1Like



LeeFarnam, Contributor

Comments (56) | + Follow

In addition, while the company talks about three permits out of five (though only two fall under the name Secure), the total *already permitted* industrial surface water usage from Lake Sakawea seems to be north of 50,000 acre feet. Contrast this with the 26,572 in actual usage in 2017. Seems like there is a lot of undrawn capacity, including on both of Secure's permits which, according to regulators, shows

only 300 acre feet used in 2017 out of the sum of the two Secure permitted volume of nearly 7000 (4900 + 1950) acre feet.

07 Jun 2018, 11:16 PM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

First, *excellent* research. It will take a little while to go through all that detail. They do discuss the Bakken capacity issues on the Q1 conference call. Currently, I understand there to be two pipeline systems. One is very actively used and the other not so much. They are building a third pipeline which they say will use all of their available water capacity.

Second, I think I have made it clear to people (even when they wanted to suggest otherwise) that WTTR does not have a monopoly or anything resembling it. This, like most other businesses, is still a competitive business. But, when looked at as a whole, they enjoy a very protected position. Coca Cola may have a wide moat, but that doesn't mean there isn't also Pepsi, and lots of other cola and soft drink manufacturers. It's just about overall perspective. As I said, the proof is in the pudding and if it were that easy there would be half a dozen large scale water companies.

As for Tetra, the company cited them as the next largest water logistics company. They recently had an analyst day so there is a lot of good stuff on their site. As they themselves concede in their presentation, they are NOT in the water sourcing business. They did not address why in their presentation. So, the fact that they applied for a whopping application is fascinating information. The fact that they were denied is telling. Obviously, they WANT to be in the water sourcing business.

From the language used in the 10K, "it has been decided that there will be no new water permits issued within 25 miles of a permit associated with an existing intake location," my guess is that was not the earlier rule. Tetra made the application, it was too close to an existing location, and they were denied. I'm just guessing at that but plan to do more research. If so, and the fact that Tetra has not subsequently been granted any sort of permit, would actually support my thesis of a wide moat. Since you are already far more advanced in your research, would appreciate any links to where you got your information from.

Interesting that they applied for so much water relative to what WTTR has. Maybe they don't know what they are doing. This suggests that there are also limits as to how much water you can take from the lake. I mean, I'm sure if WTTR needed it, they would have applied for more capacity as well.

08 Jun 2018, 05:26 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

From the Q1 CC, there are two pipeline systems, the Charlson and the Iverson. The first has very high utilization, the second not so much because there is not so much fracking in the area and there are also other competitive sources of water. The company is building out a third pipeline which is 90% finished and should be ready to go very shortly it sounds like. The company is in final negotiations with an anchor customer. Obviously, this should provide incremental revenue from the Bakken.

08 Jun 2018, 05:58 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Lee, above you said "Secure" but I think you meant "Select."

Not sure if this is helpful, but I count 1,240 industrial applications. 115 were conditionally approved. 78 void. 55 deferred. 54 denied. 59 perfected. 43 cancelled. 10 processing. Most seem unrelated to energy but Continental, EOG, and others have all made applications with mixed degrees of success.

08 Jun 2018, 11:01 AM Reply1Like



LeeFarnam, Contributor

Comments (56) | + Follow

Thanks. Lake Sakakawea is about 180 miles long and between 2 and 14 miles wide with a total shore length of 1320 miles. Presuming that this 25 mile permit exclusivity is based on shore length distance (quite likely) that allows many, many potential intake points.

I think the probing behind my questions and research is this: if there is **any** competitive advantage in water sourcing it is to come from cost, location, or scarcity. Given that public water is likely the cheapest source in most basins the question then becomes is there any competitive advantage derived from the company's exclusivity or location of licenses. (these questions I'm targeting more specifically at the Bakken, since that is where the company chooses to emphasize it's strategic water sources and where public water is definitely the cheapest option, whereas this might not be the case in other, drier basins).

It does not **appear**, based on the reading I've done so far, that the company derives any real competitive advantage from the sourcing of water in the Bakken given that a) everyone probably has the same cost from the public water commission, b) there seems to be a very adequate supply of current capacity, and c) there seems to be a very adequate supply of additional permittable inventory by

the state government. This question may hinge on the 3rd permit on the lake, which is held by a Select subsidiary which does not share a name with the parent.

That does not sink the thesis whatsoever as this inquiry is pointed at the Bakken and the company can still derive competitive advantage from other parts in the value chain, but it does I think strike at what appeared at first glance to be a very valuable part of the moat.

08 Jun 2018, 11:24 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

As for the water rights issue, I don't want to either overplay it or underplay it. As I suspect you understand, water is rarely truly scarce.

The fact that Tetra was denied/voided on the license is interesting and tends to support the idea that the current permits are quite valuable. Why were they voided? I may just lob a call into North Dakota today.

It also shows that Tetra really does want to get into the sourcing business in the Bakken at least. And, apparently, they cannot. FWIW, their application was dated January 2017. So, at least in the Bakken, WTRR's largest competitor wanted a permit and could not get one.

The company did say on the CC that the reason the Iverson line was not heavily utilized is because there was not much fracking and there are competitive sources of water, so obviously there are other ways to get water.

08 Jun 2018, 11:34 AM Reply0Like



LeeFarnam, Contributor

Comments (56) | + Follow

I'm not sure I read the same thing into the Tetra decision but I'd be interested to hear the answer nonetheless if you manage to get one!

A great report nonetheless. Very well researched, so thanks for sharing!

08 Jun 2018, 11:37 AM Reply2Like



LeeFarnam, Contributor

Comments (56) | + Follow

Permit #1

Beneficial Use Date 2015-02-01

County McKenzie

Basin Lake Sakakawea

Aquifer

Status Active

Source Surface Water

Req. Acre Feet 1950

Req. Acres 0

Req. Pumping Rate 1680

Reported Water Use

Year Acre Feet Acres Rate

2017 304.1 0 1680

2016 304.94 0 1680

2015 216.5 0 0

2014 115.5 0 1200

2013 67.05 0 1680

2012 0 0 0

Permit #2

County Williams

Basin Lake Sakakawea

Aquifer

Status Active

Source Surface Water

Req. Acre Feet 4900

Req. Acres 0

Req. Pumping Rate 3000

Req. Storage 0

Reported Water Use

Year Acre Feet Acres Rate

2017 0 0 0

2016 0 0 0

2015 0 0 0

2014 0 0 0

2013 0 0 0

2012 0 0 0

07 Jun 2018, 11:22 PM Reply2Like



ujjwal dey

Comments (3) | + Follow

Mr. Bert, really appreciate an article like this!! 👍

08 Jun 2018, 03:33 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Krypto, I've always believed that you make most of your money from a few really good ideas and so you have to maximize those few really good ideas. Look at Murray Stahl and TPL. 99% of investors just wouldn't have the courage to do what he did. **He is an iconoclastic individual.** What would Murray Stahl's 20 year performance record look like if he kept TPL at a 3% position and no more?

Where are you going in August? West Texas in August sounds hot, but also quite fascinating. Sounds like a fun road trip.

08 Jun 2018, 06:26 PM Reply2Like



Krypto

Comments (4125) | Following

Mr Bert: I'm taking my son out to USC in the middle of August and rented an SUV to take all his stuff, so I'm just going to have a wandering drive back, and I might as well learn something useful on the boring ride back without him.

Going to sleep in El Paso the night before then take a trip on 62, cut across to Orla, then go down 285 to Pecos.

That seems to be the goldmine at the moment in the middle of the Delaware where TPL has so much land, and I imagine WTTR has extensive operations, too.

My allocation with TPL started at only 10% of my portfolio, but it has grown to 50%, and I can't find any reason to sell it other than it violates portfolio theory to be that concentrated.

09 Jun 2018, 08:27 AM Reply2Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Sounds like a truly ridiculous side-journey for anyone other than people like us! Frankly. I'm jealous!!! I would love to drive through West Texas and see what's going on there. I'm sure there are some good clubs and brothels along the way. Not that I'm into that kind of stuff.

09 Jun 2018, 08:46 PM Reply1Like



OrangeClown

Comments (273) | + Follow

Mr Bert,

You must be aware of the bottlenecks in Permian. If WTI does down and there is some sort of production growth impact in the Permian, how much can that effect WTTR?

09 Jun 2018, 01:03 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Did you see the addendum to my report which specifically discussed this issue?

The reality is that the impact of the Permian bottleneck is difficult to assess on an individual company basis. If you have reserved takeaway capacity, then you are not really impacted at all. Therefore, I expect that for the major drillers this is a non-event. They have their takeaway capacity reserved. The situation may be different for the private equity players who probably wing it more and have not reserved takeaway capacity. Even if they did not reserve takeaway capacity, they are OK if they have hedged basis differentials, which I understand 15-20% of them have done. Also, there is rail and trucking capacity so if oil stays in the \$65-70 range and shipping costs are \$10-15, you are still in the \$50-60 range for what you sell. Most E&P's set their budget at \$55 and many have sold hedges at that price.

For the pressure pumpers, which were smacked good on Friday, I think the fear is that a softening of activity will impact pricing. Once again, this is difficult to determine on an individual company level. PUMP, who is focused solely on the Permian and would be the poster child for any issues there, say there is plenty more demand than supply for their services. They note that the major operators are their customers and they are the ones who will not be impacted by any slowdown.

So, I think that the problems will accrue to the smaller private equity sponsored drillers and the tier-2 pressure pumpers such as BAS, which is already reporting a very competitive environment.

As for WTTR, the Permian is 1/3 of their business. I suspect their customer base is weighted toward the larger companies doing larger fracks but don't know that for sure. So, worst case, if you have a 5% slowdown in activity, you get a 1.7% slowdown in WTTR's revenues. Given that they operate nationwide they can probably recoup some of that revenue from other basins. According to their CC, they are currently still importing equipment into the Permian, so obviously they are running at near full capacity there.

In other words, for WTTR much ado about nothing. If you believe my analysis, the stock is worth \$26 to \$33 today, and you WANT to be in the Permian. Unless you are a rapid fire trader who doesn't care about any of that, why would this cause you to sell your stock?

FINALLY, as an offsetting matter, the world is counting on a significant increase in Permian supplies. That's what's priced into oil. If you can a meaningful shortfall in Permian supplies, oil prices will likely be higher.

09 Jun 2018, 11:33 AM Reply4Like



Khursheed Brothers, Contributor

Comments (40) | + Follow

In your FCF analysis, you subtract capex from EBITDA and call the difference free cash flow. Is tax not a cash outflow? Can you explain why you did not indicate that this is pre-tax? Thanks.

09 Jun 2018, 08:05 PM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Excellent question. Q1:18 taxes were negligible. I discussed the matter with the company and, frankly, have lost my notes. In fact, I was looking for them. My recollection is that the tax rate would be very low for some time but, alas, I cannot quite remember why or for how long. I guess I should put this on my to-do list. Sucks to be old.

09 Jun 2018, 08:33 PM Reply1Like



OrangeClown

Comments (273) | + Follow

Thank you Sir Bert. I bought on Thursday and got smacked on Friday. LOL. Should have purchased more options when it went down 5%. I mainly bought \$10 strike 2019 calls I think options calls is a better way to play-. I fully believe in your analysis and will stay the course. Cheers and thanks again for the taking out the time to reply.

09 Jun 2018, 09:23 PM Reply0Like



DapperDan

Comments (322) | + Follow

Truly impressive work Mr. Bert. Thank you for putting in the time and effort to put this together.

09 Jun 2018, 11:55 PM Reply0Like



MJ-07

Comments (376) | + Follow

Mr. Bert, A great article, indeed. I hope management will take your advice and create a buyback program, and not dilute with stock options/grants. Perhaps they will get bought out if the stock price remains undervalued for too long.

10 Jun 2018, 08:49 AM Reply1Like



Comments (4125) | Following

MJ-07: I'm almost certain they cannot create stock options or grants.

The previous president, Roy Thomas, addressed that issue.

It was in Will Deener's column in the Dallas Morning News.

The article pasted below is what made me buy my first shares.

www.dallasnews.com/...

From that linked article:

Now here's the interesting part and why investing in this company seems so enticing. When the trust sells land or is paid royalties or other fees for things like grazing or easements, it uses that cash to buy back its shares.

"Buying back shares and retiring them is really the main thing we do with our cash flow," Thomas said. "We only retire shares. The trust is prohibited from reissuing shares or giving me shares because someone thinks I'm doing a good job."

Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Also, thanks for the heads-up on the articles. Looks like they are very timely and well worth reading. If you have access to these articles, would really appreciate a copy. PM me if you wish.

www.oilandgasinvestor....

11 Jun 2018, 06:57 AM Reply1Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

Goldman Sachs came out this morning with very negative comments on the frac sand players. Basically, exactly what I spoke about--a ton (actually, many tons) of supply coming on which will eventually result in a sharp decline in price.

11 Jun 2018, 09:37 AM Reply0Like



Mr. Bert, Contributor

Comments (453) | + Follow

Author's reply »

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Select Energy: A Brief But Important Follow-Up

Jun. 11, 2018 9:42 AM ET

|

About: [Select Energy Services \(WTTR\)](#), Includes: [PUMP](#), [XOM](#)



Mr. Bert

Summary

Stocks associated with U.S. shale drilling and fracking have been hit especially hard in the past ten trading sessions. This is despite general stability in the broader energy sector.

Concerns over Permian pipeline takeaway capacity, and its impact on short term Permian drilling and fracking activity, are being massively overblown in the market.

Under almost any conceivable set of circumstances, **Permian drilling and fracking will continue to grow significantly**. For interested readers, I present the mathematics behind my conclusions.

I expect WTTR to continue to grow revenues at about 20% annually for the foreseeable future. Earnings and free cash flow growth will be considerably greater.

This is a brief but important follow-up to my [initial article](#) on Select Energy Services ([WTTR](#)). **It also has significant relevance to all Permian-related companies, whether in the E&P, pressure pumping or sand business.**

The article is a bit dense with calculations, but they are important and I urge readers to take the time to understand what I am saying.

INTRODUCTION

After a great trading day Thursday (up 6.7% on very heavy volume), shares of WTTR declined on Friday (down 4.7% on lighter volume). Friday's decline was in concert with a continued further decline in the pressure pumping stocks, particularly. I believe this was related to a broker downgrade amid increasing concerns that insufficient Permian takeaway capacity could lead to a slowdown in drilling and fracking activity in that most important basin.

While I addressed this issue in my original article, Friday's market action makes it clear that this matter needs further clarification and quantification.

Perhaps even more importantly, I also explain why the base level of Permian drilling will almost inevitably **have** to grow significantly. Any future cyclical declines in drilling and fracking activity will almost certainly be shallow and swift, which is in sharp contrast to the longer cycle offshore projects.

PROPETRO: EYE OF THE STORM

Let's take a look at the chart of ProPetro Holding ([PUMP](#)). PUMP is a \$1.7 billion enterprise value pressure pumper with 100% exposure to the Permian Basin. It is therefore the poster child for Permian-related takeaway capacity fears.

As can be seen below, the stock has recently declined from a high of almost \$21 to a most recent close of \$14.25. Astonishingly, the stock is essentially back to its IPO levels of March 2017, when oil was under \$50 and the Permian rig count was 308. Today, oil is \$66, the Permian rig count is 480, and business is booming.



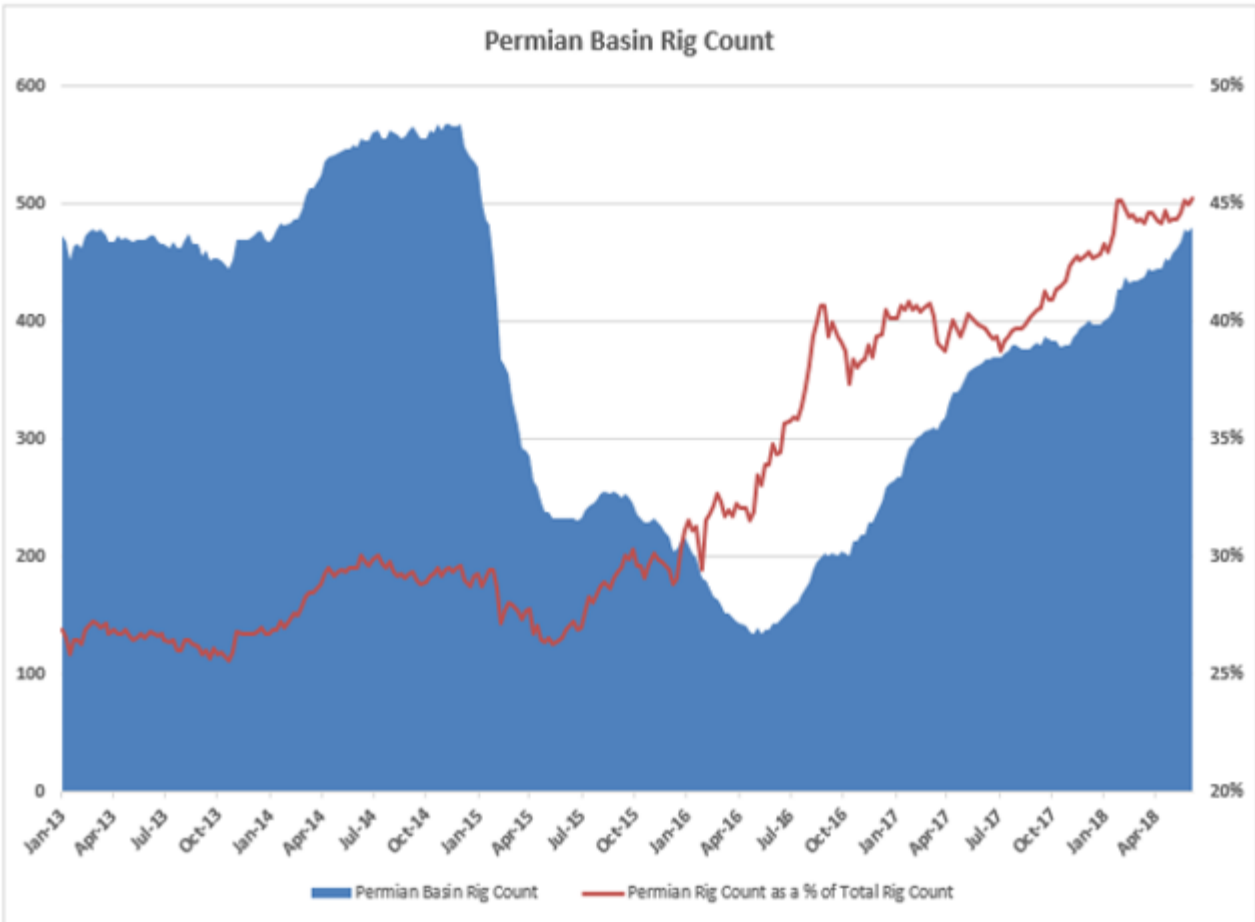
This is ridiculous and let me now explain why.

PERMIAN ACTIVITY

Let's think about this. The Permian Basin is the hottest drilling play on the planet and, as a result, oil production has now surpassed the region's pipeline takeaway capacity. While significant new pipeline capacity is coming, this is now causing investors to dump the stocks over what is, in the very very worst case, a temporary reduction in the rate of rig additions.

In 2014-17, the oilfield services stocks declined significantly because oilfield activity declined significantly amidst low oil prices and excess inventory. That makes sense. But for the stocks to decline significantly because activity is **too strong** makes no particular sense, particularly when inventories are balanced and longer-term oil fundamentals are excellent. This is what they would call a first world problem.

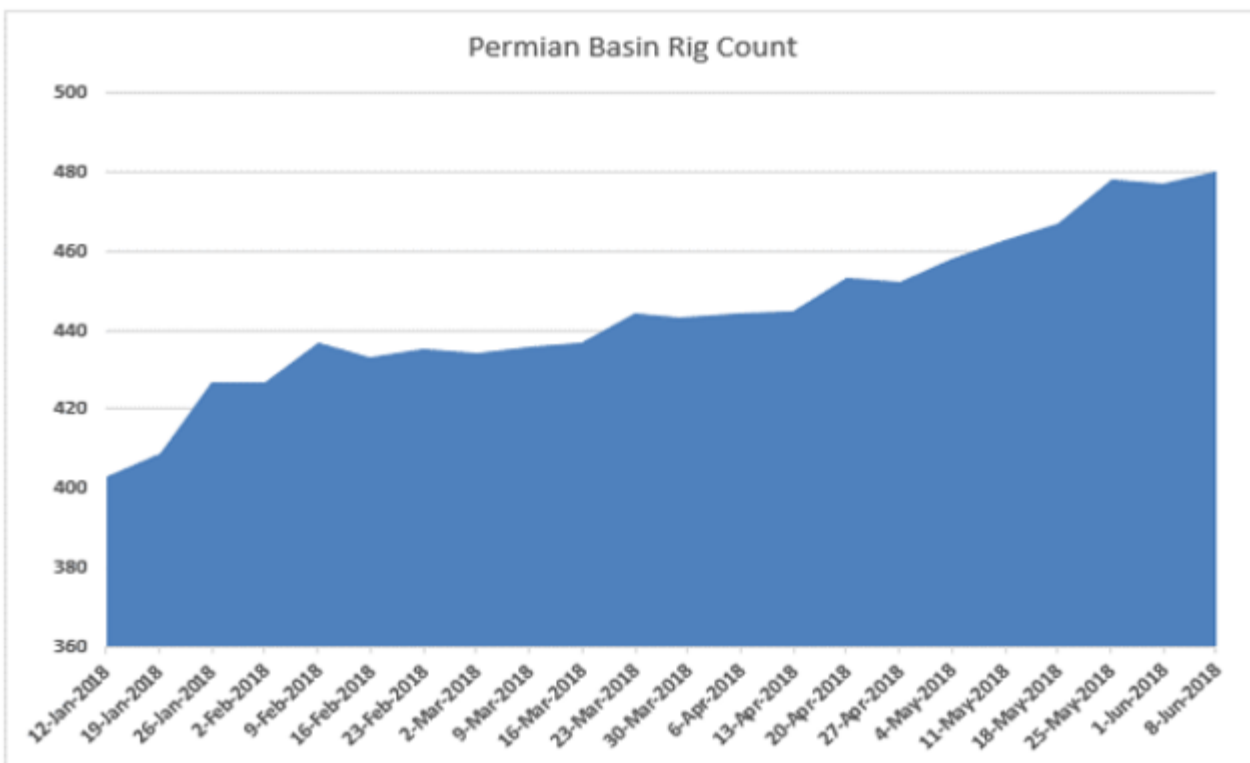
First, let's look at the recent history of drilling in the Permian.



Source: Baker Hughes

As can be seen above, the Permian is on fire. Since bottoming in April 2016, the Permian rig count has well more than tripled, increasing from 132 to 480. Almost all those rigs are drilling for oil. The Permian now accounts for about 45% of all drilling activity making it, by far, the most important shale oil basin in the country.

The matter of Permian takeaway capacity has been topical since March, with basis differentials beginning to widen and then blowing out in April and May. Yet, during this time actual Permian activity has increased significantly as can be seen in the expanded chart below.



Source: Baker Hughes

Since the beginning of the year, the Permian rig count has increased 20%. Even since March, when the basis differentials started widening, the Permian rig count is still up 10%. What gives?

SHALE DRILLING – ACCELERATED DECLINE RATES

Now, let's talk about why, for the foreseeable future, the level of Permian oilfield activity must not only increase, but must also stay elevated. **A decline of the sort seen in 2015-16 will likely never be seen again. I cannot overestimate the importance of understanding this math.**

An oil well declines over time—it's a simple matter of geology and physics. Bigger wells tend to decline much more slowly than smaller wells. Imagine putting a hole in a big blimp. It will take a long time for all the air to escape. As the internal pressure declines, so will the rate of flow; but it will be gradual. Now imagine releasing the air from a tire. The air will rush out, and the rate of flow will decline very quickly. In almost no time at all, the tire will be essentially empty and the flow will be a fraction of where it started. The concept is similar in oil wells: big ones deplete slowly and gradually, while small ones yield their oil in a rapid burst.

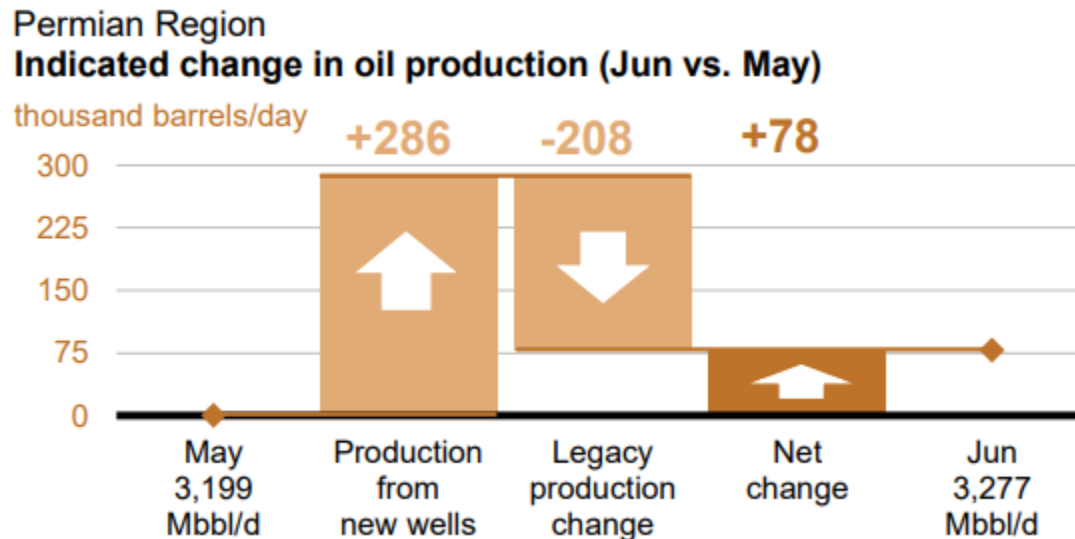
On a global basis, most estimates of the aggregate decline rate are about 6-7% per annum. That is, the average conventional well will naturally decline at about that rate. That means that after five years, the well will be producing at a rate about one-quarter less than it did initially.

But shale wells are not like conventional wells and have an incredibly accelerated rate of decline. A typical shale oil well peaks around its first month, and then declines very rapidly thereafter. First year decline rates are typically on the order of 50-60%, meaning that at the

end of its first year, production has already declined by that amount. Second year decline rates are on the order of 30% so, after just two years, oil production has declined by almost 90%.

What does this mean? Essentially, it means that to produce a continuously growing stream of oil, you need to continuously increase your rate of drilling. Any decrease in the rate of drilling will result in a quick and steep decline in production.

Let's take a look at the U.S. Energy Information Agency's (NYSEMKT:[EIA](#)) most recent Drilling Productivity Report for May 2018.



Source: Energy Information Administration ([EIA](#))

For the Permian Basin, May oil production was 3.199 mmbpd. According to the EIA, production from new wells added about 286 kbpd of production during the month, while production from existing wells declined by about 208 kbpd during the month, leading to an estimated net increase of 78 kbpd.

So, think about it. At the beginning of May, existing wells were pumping at a rate of 3,199 kbpd and by the end of the month those wells were producing only 2,991 kbpd, a decline of 208 kbpd just during the month. In just one month, **existing production declined 6.5%**.

RUNNING ON THE TREADMILL

Thus, the production of shale oil has significant elements of running on a treadmill. That is, you must keep running at a certain pace just to stay even. Stop running, or even slow down for a moment, and you can start to move backwards.

In other words, even if you only want to maintain flat production, you must do a lot of drilling just to offset the accelerated decline rate that shale wells display. If you want to grow production, you will have to do even more drilling. Finally, (bonus points if you are astute enough to see where I am going), the greater the production rate, the greater the number of rigs required to maintain flat production.

Let's take a look at the math.

Currently, monthly production in the Permian is 3,199 kbpd and the monthly decline rate is 208 kbpd. Each rig currently contributes about 635 bpd of new production. That means, of the 450 rigs working in the Permian now, 328 of them, or 73%, are working just to keep production from declining. If you stop drilling for a month, your production will decline 6.5%. If you stop drilling for three months, your production will decline more than 20%. E&P companies never like to see even short-term declines in their production.

Now let's fast forward two years to May 2020 when daily Permian oil production is expected to be around 5,200 kbpd. Assuming the decline rate stays proportionally about the same, the monthly decline will be about 338 kbpd. **Assuming the productivity per rig also stays roughly the same, the number of rigs needed simply to maintain production will be 532 rigs**—significantly greater than the current number of rigs needed today to maintain and grow production. In other words, in just two years, the base level of activity, defined as the number of rigs needed to keep production flat, will increase by 62%. That's incredibly important.

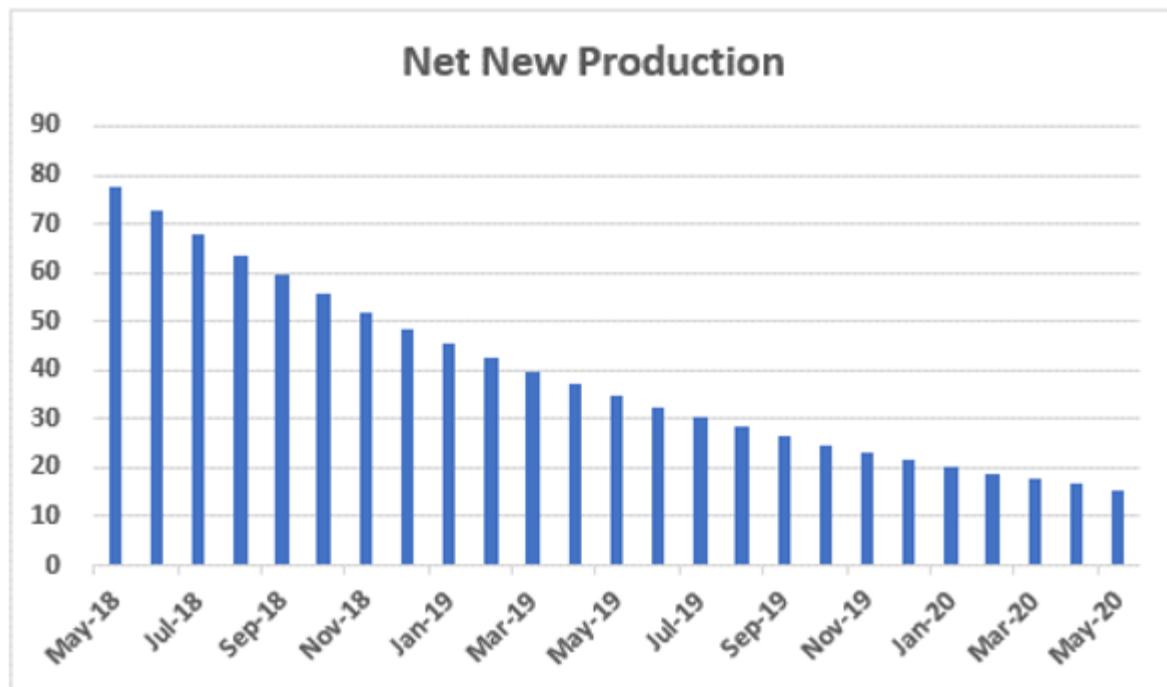
For those of you interested in the detail, I've modeled out what production would look like in two years with a flat rig count. Every model needs its simplifying assumptions and mine are that the productivity per rig stays flat at 635 bpd and the legacy decline rate stays flat at 6.5% per month. I believe that both are reasonable approximations of reality.

Flat Rig Count Case

Date	Rigs Operating	Change in Rigs	Rigs to Maintain Production	Total Rig Months	Production per Rig	Monthly Production (kbpd)	Legacy Decline (kbpd)	New Production (kbpd)	Net New Production (kbpd)	Total Production (kbpd)
May-18	450	0	328		635	3,199	(208)	286	78	3,277
Jun-18	450	0	336	450	635	3,277	(213)	286	73	3,349
Jul-18	450	0	343	450	635	3,349	(218)	286	68	3,417
Aug-18	450	0	350	450	635	3,417	(222)	286	64	3,481
Sep-18	450	0	356	450	635	3,481	(226)	286	59	3,540
Oct-18	450	0	363	450	635	3,540	(230)	286	56	3,596
Nov-18	450	0	368	450	635	3,596	(234)	286	52	3,648
Dec-18	450	0	374	450	635	3,648	(237)	286	49	3,696
Jan-19	450	0	378	450	635	3,696	(240)	286	45	3,742
Feb-19	450	0	383	450	635	3,742	(243)	286	42	3,784
Mar-19	450	0	387	450	635	3,784	(246)	286	40	3,824
Apr-19	450	0	392	450	635	3,824	(249)	286	37	3,861
May-19	450	0	395	450	635	3,861	(251)	286	35	3,896
Jun-19	450	0	399	450	635	3,896	(253)	286	32	3,928
Jul-19	450	0	402	450	635	3,928	(255)	286	30	3,959
Aug-19	450	0	405	450	635	3,959	(257)	286	28	3,987
Sep-19	450	0	408	450	635	3,987	(259)	286	27	4,013
Oct-19	450	0	411	450	635	4,013	(261)	286	25	4,038
Nov-19	450	0	413	450	635	4,038	(263)	286	23	4,061
Dec-19	450	0	416	450	635	4,061	(264)	286	22	4,083
Jan-20	450	0	418	450	635	4,083	(265)	286	20	4,103
Feb-20	450	0	420	450	635	4,103	(267)	286	19	4,122
Mar-20	450	0	422	450	635	4,122	(268)	286	18	4,140
Apr-20	450	0	424	450	635	4,140	(269)	286	17	4,157
May-20	450	0	426	450	635	4,157	(270)	286	15	4,172

Source: Author's calculations

As can be seen, keeping the rig count flat at May's level of 450 would yield growth in production to 4,172 kbpd by May 2020. By that point, however, net monthly production growth would slow from 78 kbpd to just 15 kbpd because more and more of the rigs will be working just to maintain production.

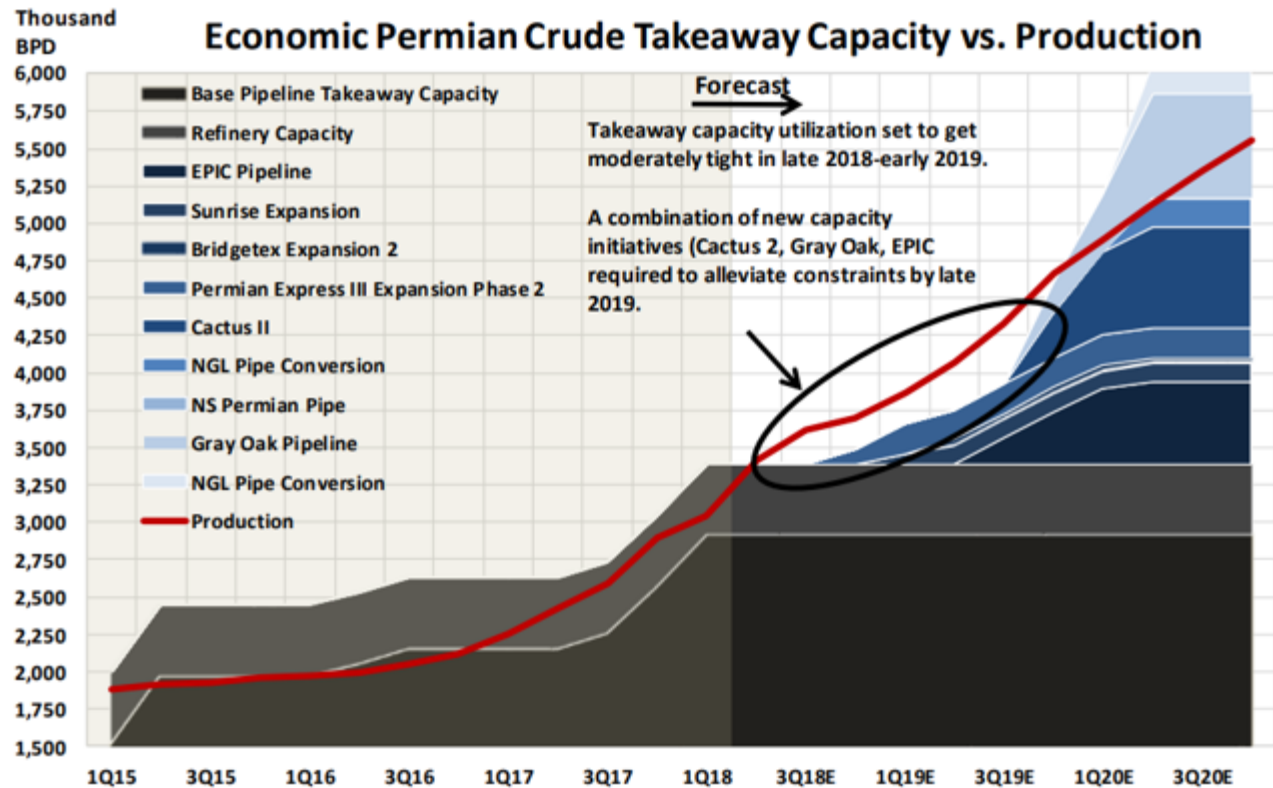


Source: Author's calculations

In fact, by May 2020, 426 of the rigs, or 95%, will be dedicated just to keeping production flat.

(In this function, net new production will decline asymptotically toward zero, with all 450 rigs eventually being used simply to keep production flat.)

Now, let's go back to this chart from Raymond James, showing forecast Permian oil production versus pipeline takeaway capacity.



Source: Raymond James research report

As can be seen from the red line above, current production is about 3,199 kbpd and is forecast to grow to about 4,500 kbpd by September 2019 and 5,200 kbpd by June 2020.

As can also be seen above, there is currently about 3,350 kbpd of pipeline takeaway capacity. This pipeline capacity continues to grow modestly from the expansion of the Permian Express III pipeline until the third quarter of 2019, at which point it jumps dramatically as significant new capacity comes online.

So, let's examine two scenarios, both using a June 2020 endpoint. In the first scenario, production is unconstrained by any takeaway capacity. Here, as shown in the red line above, production is expected to grow more or less linearly from 3,199 kbpd currently to about 4,500 kbpd by September 2019, and then on to about 5,200 kbpd by June 2020.

As shown below, I calculate that this will require the steady addition of about 9 rigs per month to achieve this type of net production growth. By May 2020, the Permian rig count would be 657 and about 524 of them would be required just to maintain production flat at that level.

Unconstrained Case

Date	Rigs Operating	Change in Rigs	Rigs to Maintain Production	Total Rig Months	Production per Rig	Monthly Production (kbpd)	Legacy Decline (kbpd)	New Production (kbpd)	Net New Production (kbpd)	Total Production (kbpd)
May-18	450		328		635	3,199	(208)	286	78	3,277
Jun-18	450	9	336	450	635	3,277	(213)	286	73	3,349
Jul-18	459	9	343	459	635	3,349	(218)	291	74	3,423
Aug-18	468	9	351	468	635	3,423	(223)	297	75	3,498
Sep-18	477	9	358	477	635	3,498	(227)	303	75	3,573
Oct-18	486	9	366	486	635	3,573	(232)	309	76	3,649
Nov-18	495	9	374	495	635	3,649	(237)	314	77	3,727
Dec-18	504	9	382	504	635	3,727	(242)	320	78	3,804
Jan-19	513	9	390	513	635	3,804	(247)	326	78	3,883
Feb-19	522	9	398	522	635	3,883	(252)	331	79	3,962
Mar-19	531	9	406	531	635	3,962	(258)	337	80	4,041
Apr-19	540	9	414	540	635	4,041	(263)	343	80	4,121
May-19	549	9	422	549	635	4,121	(268)	349	81	4,202
Jun-19	558	9	430	558	635	4,202	(273)	354	81	4,283
Jul-19	567	9	439	567	635	4,283	(278)	360	82	4,365
Aug-19	576	9	447	576	635	4,365	(284)	366	82	4,447
Sep-19	585	9	455	585	635	4,447	(289)	371	82	4,529
Oct-19	594	9	464	594	635	4,529	(294)	377	83	4,612
Nov-19	603	9	472	603	635	4,612	(300)	383	83	4,695
Dec-19	612	9	481	612	635	4,695	(305)	389	83	4,778
Jan-20	621	9	489	621	635	4,778	(311)	394	84	4,862
Feb-20	630	9	498	630	635	4,862	(316)	400	84	4,946
Mar-20	639	9	506	639	635	4,946	(322)	406	84	5,030
Apr-20	648	9	515	648	635	5,030	(327)	411	84	5,114
May-20	657	9	524	657	635	5,114	(333)	417	85	5,199

Total Rig Months		13,284
Total Oil Production kbpd		3,161

Source: Author's calculations

During this period, the industry will use about 13,284 rig-months and produce about 3,161 million barrels of oil. (Total oil production for the period is derived by multiplying daily total production by 30 and summing for each month in the period. Daily total production is the right most column in the chart above.)

Now let's consider the more likely case where production is constrained by pipeline capacity, but where there is also some limited rail and trucking capacity.

According to Goldman Sachs, there is approximately 125-150 kbpd takeaway capacity by rail, which will cost about \$7-9 per barrel in incremental transportation cost. There is also some amount of trucking capacity which will cost \$10-15 in incremental transportation. According to Goldman, each truck can carry 180 barrels and it takes 1.5 to 2.0 days per round trip. Therefore, on a dedicated basis, one truck can transport about 100 barrels a day and therefore, 1,000 trucks can transport about 100,000 barrels a day.

For the purposes of my model, I assume 137.5 kbpd (the mid-point of Goldman's range) of oil will be transported by rail, which is still quite economical at current oil prices. I also arbitrarily assume that 100 kbpd can be transported by truck, which is also economical at current prices. I suspect that actual trucking capacity could be significantly greater. (Despite a nationwide shortage of truck drivers, high value cargoes such as an oil tanker truck would likely be able to find drivers. With 3.5 million truck drivers in the U.S., finding an incremental couple of thousand should not be an impossible task.) I further assume that it will take six months for capacity to ramp up to these levels. Adding that to the pipeline

capacity (which I have estimated from the Raymond James chart), I calculate total Permian takeaway capacity as follows:

Date	Pipeline Capacity kbpd	Rail Capacity kbpd	Truck Capacity kbpd	Total Capacity kbpd
May-18	3,350	23	17	3,390
Jun-18	3,350	46	33	3,429
Jul-18	3,350	69	50	3,469
Aug-18	3,388	92	67	3,546
Sep-18	3,425	115	83	3,623
Oct-18	3,457	138	100	3,694
Nov-18	3,488	138	100	3,726
Dec-18	3,520	138	100	3,758
Jan-19	3,580	138	100	3,818
Feb-19	3,640	138	100	3,878
Mar-19	3,700	138	100	3,938
Apr-19	3,742	138	100	3,979
May-19	3,783	138	100	4,021
Jun-19	3,825	138	100	4,063
Jul-19	3,900	138	100	4,138
Aug-19	4,063	138	100	4,300
Sep-19	4,225	138	100	4,463

Source: Raymond James, Goldman Sachs, author's calculations

(After September 2019, pipeline capacity will be in surplus and therefore will not be a constraining factor to production.)

Let's now try and adjust the rig count so that total production will still fall under the takeaway capacity.

Production Constrained Case

Date	Rigs Operating	Change in Rigs	Rigs to Maintain Production	Total Rig Months	Production per Rig	Monthly Production kbpd	Legacy Decline kbpd	New Decline kbpd	Net New Production kbpd	Total Production kbpd
May-18	450		328		635	3,199	(208)	286	78	3,277
Jun-18	450	4	336	450	635	3,277	(213)	286	73	3,349
Jul-18	454	4	343	454	635	3,349	(218)	288	71	3,420
Aug-18	458	4	350	458	635	3,420	(222)	291	68	3,488
Sep-18	462	4	357	462	635	3,488	(227)	293	67	3,555
Oct-18	466	4	364	466	635	3,555	(231)	296	65	3,620
Nov-18	470	4	371	470	635	3,620	(235)	298	63	3,683
Dec-18	474	4	377	474	635	3,683	(239)	301	62	3,744
Jan-19	478	4	383	478	635	3,744	(243)	304	60	3,804
Feb-19	482	4	390	482	635	3,804	(247)	306	59	3,863
Mar-19	486	4	396	486	635	3,863	(251)	309	57	3,921
Apr-19	490	4	401	490	635	3,921	(255)	311	56	3,977
May-19	494	4	407	494	635	3,977	(259)	314	55	4,032
Jun-19	498	4	413	498	635	4,032	(262)	316	54	4,086
Jul-19	502	15	418	502	635	4,086	(266)	319	53	4,139
Aug-19	517	15	424	517	635	4,139	(269)	328	59	4,198
Sep-19	532	15	430	532	635	4,198	(273)	338	65	4,263
Oct-19	547	15	437	547	635	4,263	(277)	347	70	4,333
Nov-19	562	15	444	562	635	4,333	(282)	357	75	4,408
Dec-19	577	15	451	577	635	4,408	(287)	366	80	4,488
Jan-20	592	15	460	592	635	4,488	(292)	376	84	4,572
Feb-20	607	15	468	607	635	4,572	(297)	385	88	4,660
Mar-20	622	15	477	622	635	4,660	(303)	395	92	4,752
Apr-20	637	15	487	637	635	4,752	(309)	404	95	4,848
May-20	652	15	496	652	635	4,848	(315)	414	99	4,947

Total Rig Months	12,509
Total Oil Production kbpd	2,894

Source: Author's calculations

There are many ways to adjust the rig count trajectory to accomplish this, and I have chosen one which divides the rate of rig count growth into a constrained and an unconstrained period. As can be seen above, during the constrained period, the rig count needs to grow at the rate of about 4 rigs per month. This would allow production to grow but remain under the total takeaway capacity. Beginning July 2019, the rig count would then need to grow by 15 rigs per month so that June 2020 can come close to the targeted level of about 5,200 kbpd while still remaining consistent with longer term growth trends after that. Under this scenario, the industry would require 12,509 rig-months during this period, and total oil production would be 2,894 million barrels.

So, let's summarize.

As of May 2018, the Permian was producing 3,199 kbpd. The decline in production from existing wells was 208 kbpd, or 6.5% of total beginning production. The industry was employing 450 rigs with each rig adding 635 bpd of new production for a total of 286 kbpd in new production, resulting in net production growth of 78 kbpd.

In the unconstrained case, production rises more or less steadily to about 5,200 kbpd in June 2020. To achieve this type of growth, the industry needs to add about 9 rigs per month. By June 2020, monthly production will be about 5,199 kbpd, the industry will be employing 657 rigs, of which 524 will be need simply to offset the decline from legacy wells.

In the constrained case, production rises to 4,947 kbpd in June 2020, and is constrained through September 2019 by the amount of takeaway capacity. In this scenario, the industry

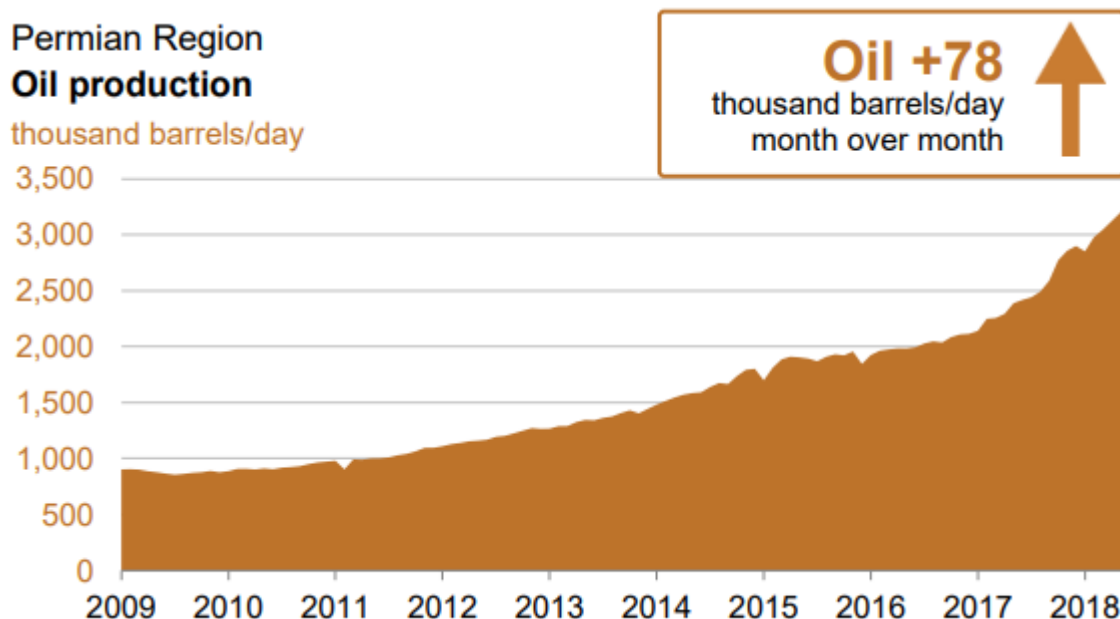
needs to add 4 rigs per month through June 2019. Beginning in July 2019, it will need to add rigs at the rate of 15 months to catch up to its trendline growth rate.

The difference between the constrained case and unconstrained case is about 775 rig-months, or a decrease of about 5.8% for this two-year period. The decrease for the first half of that period is slightly greater at 6.4%. The difference in total oil production is about 242 million barrels, or about 8.4%.

NEVER AGAIN?

Never say never, but I think there is a good case to make that the kind of sharp and sudden decline in Permian activity in 2015-16 may never occur again. The reason for this is because, as production rises, so must the number of rigs and associated fracking crews simply to maintain production flat.

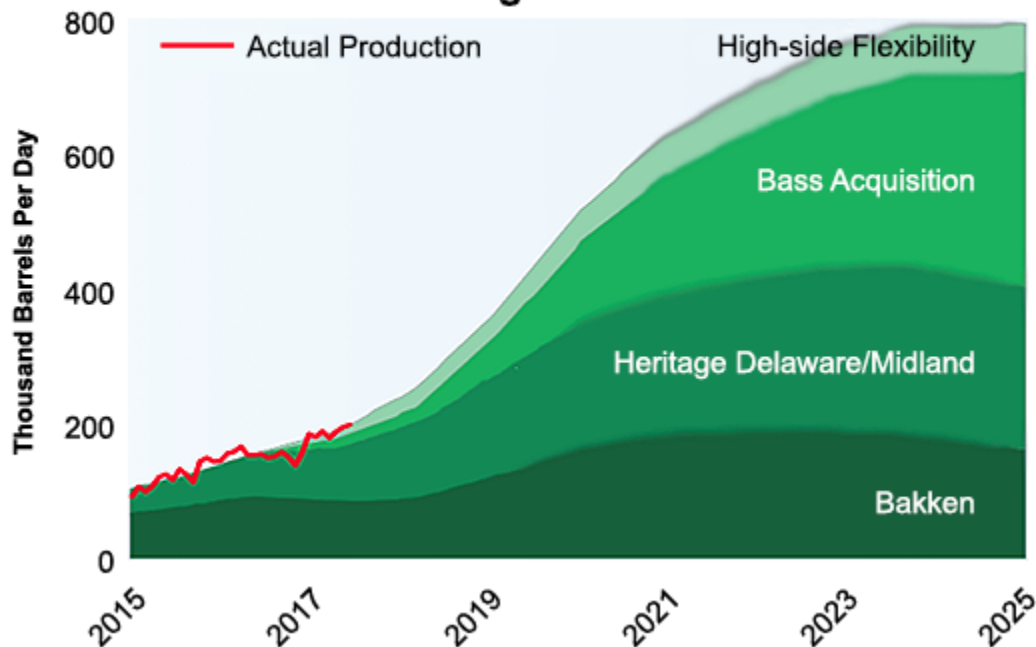
As can be seen below, oil production in the Permian has more than tripled over the past six years. Assuming stable rig productivity and decline rates, that means the number of rigs required to maintain production has also increased by roughly that amount.



Source: EIA

Over the next two years, production is expected to increase by another 60%, which means that the number of rigs and fracking crews needed just to maintain production will also need to increase proportionately. With operators such as ExxonMobil forecasting significant growth beyond 2020, production can be expected to rise significantly for years after that.

ExxonMobil Actual & Forecasted Net Production From The Delaware, Midland & Bakken Through 2025



Source: ExxonMobil

Therefore, I believe that the base level of Permian activity almost must increase significantly for at least the next five years. WTTR will be an obvious and meaningful beneficiary of that growth.

CONCLUSIONS

As I suggested in my earlier piece, any slowdown in Permian activity would amount to, at worst, a modest reduction in the growth rate. I can now reassert that conclusion with greater confidence and demonstrate the mathematics behind that conclusion.

As it pertains to WTTR, I calculate a worst case potential decline of approximately 5.8% in Permian fracking activity over the next two years. Since the Permian accounts for about one-third of WTTR's revenues, this would equate to about a 2% decrease in revenues, which is the midpoint of my earlier estimate of 1-3%. Because WTTR operates nationally, it may well be able to pick up any slack by moving some of its equipment to other basins.

So, the conclusion should be clear: drilling and fracking activity in the Permian is strong and will remain strong under pretty much any conceivable set of circumstances. The looming takeaway constraints may slow the near term growth in the rig count, but this will be significantly compensated for by much more aggressive rig count growth after July 2019, when pipeline capacity constraints begin to disappear. It's mostly much ado about nothing.

Perhaps the most important takeaway from this article for investors is the implicit growth in base drilling and fracking levels just to maintain existing production. E&P companies are loathe to allow production to decline and the accelerated decline rates of shale drilling all but ensure continued healthy activity with

minimal cyclical declines in activity. I see at least 20% organic growth over the next five years.

Disclosure: I am/we are long **wttr, lbrt**.

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A very cogent and timely addition to your original report.

The WTTR investment case is not only intact but your more-detailed analysis makes it even more compelling.

Investor worries about take-away capacity constraints is weighing on all Permian stocks -- good, bad and indifferent.

Buying a likely gem at a bargain price makes a great investment strategy.

11 Jun 2018, 10:10 AM [Reply](#)[0Like](#)



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This is a good analysis and a good read. Thank you. I am long RPC which has partial exposure to the Permian. It is down from \$25 to \$15 in the space of a few months. There has been absolutely no negative news, there is no debt payment due, there have been no safety issues. The drop, I think, is all due to this irrational idea that too much E&P activity has overtaken the existing pipeline infrastructure. I don't get it. Too much good news is still good news. I'm holding my position and fully expect RPC (and WTTR) to recover nicely.

11 Jun 2018, 10:16 AM [Reply](#)[0Like](#)



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The issue here is declining oil prices. The share prices for WTTR and the sand companies are linked to the price of oil in spite of the big drop in breakeven for the frackers. My hope is eventually market will understand unless oil goes below \$50 these guys will make huge amounts of money. Sand companies will do well too. Demand is off the charts. Water and sand are both less commodity like than the uninitiated recognize. When profit continues I hope market comes around but right now oil trend appears to be down and that will hurt these stocks. I believe it is a buying opportunity unless it turns out we get to and stay below \$50 a barrel for a long time.

11 Jun 2018, 10:33 AM [Reply](#)[0Like](#)



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What's your PT for this company Mr. Bent?