



## Halcon Resources

### Relative value

In the face of the dramatic downward shift in commodity prices over the last few months, the question hanging over the lower-rated credits is the sustainability of the business model itself. For Halcon (HK), given its high leverage levels, this issue is even more relevant. In this context, the revised outlook provided by the management earlier this week is a major positive. The company said it would contain drilling & completion capex to \$375-\$425 million, sharply below the \$1,100 million in FY 14E while keeping total production relatively flat. To place the new plan in perspective, it is just half of the previous capex budget provided in November of \$775 million while production target has been taken down by just 18%. The management is achieving this by halving its rig program from 6 to 3 – two of the rigs will now be focused on its best asset, the Fort Berthold acreage of its Bakken play. The East Texas Eagle Ford play, where the company had previously planned a ramp-up, will now be allocated a solitary rig. The revised production target also means its oil production for FY 15 is now largely hedged (88% @ \$87.29/bbl). We therefore see EBITDA of \$655 million (only 15% below FY 14E levels) with a modest cash burn of ~\$75 before asset sales despite a heavy interest burden of \$185 million (about a quarter of EBITDA). We see a largely similar financial performance in FY 16 as well – flat production levels on a ~\$500 million capex program though driving slightly higher FCF burn due to lower realization levels (negative \$85 million). Liquidity, while modest at \$797 million including \$95 million of cash, will be more than sufficient to manage the revised drilling program. Overall, while leverage levels will stay elevated (5.8x by FY 16E), the company looks reasonably well placed to service its debt through FY 16.

The longer term outlook is more challenging however. The inventory of its best asset, Fort Berthold acreage is limited and will run out over the next couple of years. Therefore, run-rate maintenance capex in the medium term will increase to above the \$400 million level. Its other assets –Williams acreage in the Bakken and East Texas Eagle Ford acreage – have considerably weaker economics, which require \$80/bbl WTI price to generate a 20-25% IRR. That said, we see the company driving considerable reductions in well costs – both due to greater efficiency and softening service costs – neither of which are factored into the above analysis. Going forward, we expect both assets to be economic at our long term oil price outlook of \$70/bbl.

On balance, we acknowledge that HK, given its high leverage levels compared to other B/CCC peers, is more vulnerable to the current commodity downturn. However, we continue to have a constructive view on the credit since we believe the risk-reward matrix is attractive. As we noted above, strong visibility from its robust hedge position and low near term maintenance capex levels provide relative stability to the company through FY 16. Longer term, we see the business stabilizing on the back of improvement in medium oil prices from current levels and strong cost efficiency gains. Admittedly, our earlier expectation of meaningful deleveraging over the medium to long term driven by strong production growth does not hold in the current environment. But with yields of 14.5-15.5%, one of the highest among B/CCC peers, investors are being suitably compensated for the additional financial risk. In particular, with bonds trading levels at or around 75, the company is trading close to our expected 2014 PV-10/debt level providing reasonable asset coverage. We maintain our BUY rating across HK bonds. Downside risks include extended period of weakness in oil prices, weaker-than-expected efficiency gains.