

Xtreme Drilling and Coil Services Corp (TSE: XDC) \$2.43

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Xtreme Drilling and Coil Services Corp (Xtreme) is an oil service company that owns and operates land drilling rigs and coiled tubing services. Over the past 9 months, the market has punished all oil related names, Xtreme included. The sell-off in Xtreme is overdone though and fails to acknowledge Xtreme's market leading position and technological advantages, particularly with their coiled tubing fleet. The company has a conservative balance sheet, protecting downside for investors. Even during the current downturn, Xtreme should generate positive free cash flow, a rare feat with current market conditions.

Ticker:	XDC	Current Price(\$CAD):	\$2.43
Action:	Long	Market Cap (\$CAD M)	\$201
Expected Timeframe:	2-5 years	Enterprise Value(\$CAD M):	\$331
Target Allocation	3-5%	Target Price (\$CAD):	\$4.38
Asset Class:	Common Equity		

Investment Overview/Background

Many investors are looking for ways to capitalize on the oil sell-off that started in 2014. The popular view is to find junior producers who will benefit from a bounce back in prices. While there is nothing wrong with that, the strategy depends almost exclusively on commodity prices. These plays are options, and an option has a time value that decays. I believe a better strategy is to find technologically advanced companies that will benefit from any rebound, but still make money in current market conditions or any further downturns. I believe Xtreme fits in that category.

During periods of turmoil in commodity markets a natural bifurcation occurs. Older, less efficient, technologies will be pushed to the side. Newer technologies can come in, gain market share, and set a new standard of operation. An example would be in the offshore drilling space, where older and less technologically advanced rigs are being displaced by newer rigs that are safer and more efficient. While technology changes rapidly, betting on the right technology, at the right price, can prove fruitful.

Xtreme operates a land drilling rig division and a coiled tubing division. Both divisions will be explored in greater detail later, but a quick overview will help. The land drilling division operates Tier 1 rigs. These rigs are best in class. While utilization has suffered during the downturn, Tier 1 rigs are far better off than lower tiered rigs, which are less efficient and will be scrapped at a much quicker pace if and when the current oil environment goes on.

The coiled tubing division has significant advantages over competitors. Xtreme offers a differentiated product that saves money, and increases productivity in oil wells. The coiled tubing division is the hidden gem for Xtreme and produces a considerable portion of its earnings power both now and is expected to so in the future.

I believe that investors today are purchasing shares of Xtreme at roughly 11-13x trough free cash flow (FCF). Most importantly, the company is producing free cash flow in the current environment. Xtreme

has a conservative balance sheet and management has made it clear that they want to lower debt going forward. If the oil sector improves, Xtreme’s utilization and dayrates should improve along with it. Even if this doesn’t happen soon, Xtreme can ride the trough out, or prosper if competitors succumb to a new normal. Under a conservative scenario I believe that there is 80% upside in shares of Xtreme, with more than 100% upside if the industry recovers quickly and Xtreme commences building new coiled tubing units.

Land Drilling Division

The land drilling division consists of 21 rigs that operate in the United States, Canada, and India. All of [Xtreme’s](#) rigs are AC powered rigs, a vast majority of them have skid systems, and all have powerful pump systems with more than 1,000 horsepower each. Being AC powered, having skid systems, and a powerful pump system are all [highly](#) valued characteristics of good Tier 1 rigs. Table 1 below shows Xtreme’s land rigs and some of their characteristics.

Table 1. Xtreme Drilling Land Rigs Source: Company Website

Rig	Model	Status	Location	Type	Pump Capacity	Top Drive	Skidding System
3	XDR 200	Idle	Canada	AC VFD	2- 1,000 hp	H 150 Ton	No
4	XDR 200	Idle	North Dakota	AC VFD	2- 1,000 hp	H 150 Ton	No
5	XDR 200	Idle	Canada	AC VFD	2- 1,000 hp	H 150 Ton	No
6	XDR 400	Operating	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
7	XDR 500	Idle	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
8	XDR 400	Idle	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
10	XDR 200	Idle	Canada	AC VFD	2- 1,000 hp	H 150 Ton	No
11	XDR 300	Idle	Colorado	AC VFD	2- 1,300 hp	AC 150 Ton	Yes
12	XDR 300	Operating	India	AC VFD	2- 1,600 hp	AC 150 Ton	Yes
14	XDR 300	Operating	India	AC VFD	2- 1,600 hp	AC 150 Ton	Yes
15	XDR 300	Idle	Colorado	AC VFD	2- 1,600 hp	AC 150 Ton	Yes
16	XDR 500	Operating	North Dakota	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
17	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
18	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
19	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 250 Ton	Yes
20	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 350 Ton	Yes
21	XDR 500	Operating	North Dakota	AC VFD	2- 1,600 hp	AC 350 Ton	Yes
22	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 350 Ton	Yes
23	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 350 Ton	Yes
24	XDR 500	Operating	Colorado	AC VFD	2- 1,600 hp	AC 350 Ton	Yes
25	XDR 500	Idle	North Dakota	AC VFD	2- 1,600 hp	AC 350 Ton	Yes

Tight oil drilling, such as shale drilling, requires multiple wells, long laterals, and fine bit positioning, all of which require rigs built to rigorous specifications. The ability to skid, for instance, can [reduce](#) drill costs by up to \$500,000 per well. SCR rigs (Silicon-Controlled Rectifier - rigs that are powered via diesel) are being scrapped as producers look to newer, better, and more profitable rigs.

At the end of the day, this is still a commodity business. During a downturn, all rigs will see rate erosion, even if drillers [turn](#) to Tier 1 rigs, while scrapping mechanical and Tier 2 rigs. During the first quarter of 2015, rates dropped by an [average](#) of 21% and many contracts were terminated. According to industry insiders, a large portion of these terminations occurred to legacy rigs, which simply cannot compete with Tier 1 rigs. In their Q1 2015 presentation, Nabors Industries, a competitor to Xtreme, noted their Tier 1 AC rigs had utilization of 72%, while their legacy rigs had 31% utilization. The table below shows dayrates for various rig types across the industry.

Table 2. Dayrates of Land Rigs. Source: [Unconventional Oil and Gas Center](#)

Size	AC Power (Tier 1)	Diesel SCR	Conv. Mechanical
1000 hp	\$18,000	\$17,000	\$16,500
1500 hp	\$19,500	\$17,500	\$15,000

Almost all of Xtreme’s rigs are 1500 hp AC rigs, the clear winner from a dayrate perspective. While rates are dropping, eventually equilibrium will be found via scrapping, or dayrate stabilization. Within the [Eagle Ford](#), Tier 1 rigs are already seeing a stabilization of dayrates. I believe that Xtreme will benefit over the long-term as older rigs are scrapped. Upon any sort of dayrate expansion, Xtreme will benefit as well, although this is not necessary for the investment to work.

Competitors have their own opinions about the recovery in rig utilization and dayrates. For example, Independence Contract Drilling (ICD) had this to say on their Q1 2015 conference call

“We think the current downturn in demand for pad optimal rigs bottoms during the third quarter (2015), flattens in the year end, and begin to recover in 2016. It’s important to note that I am not referring to AC rigs in this demand analysis, but pad optimal rigs as defined by operators.

Pad optimal rigs are not just AC driven. At this point in the rig replacement cycle, AC is a given and not a distinguishing characteristic. Rather pad optimal rigs have six specific characteristics that define them as the equipment of choice for pad development and a wellbore manufacturing model. Those characteristics are 1500 horsepower, dual fuel capabilities, (and) a 7500 PSI mud system for long laterals. They are safe by design and capable of fast conventional moves, four days released to spud, with minimized rig-related loads. They have omni-directional walking systems capable of rapidly adjusting to mis-aligned wellbores and self-leveling the rig on slope pads, as well as walking over raised well heads. And finally, they have AC drives. Rigs with those characteristics will be first to achieve a 100% effective utilization and a recovery.”—Bryan Dunn CEO of Independence Contract Drilling May 10, 2015 conference call

While it is clear that Dunn is largely talking his own book, the basic premise (older rigs get scrapped and technologically advanced rigs find work sooner) makes sense. Looking at Table 1 and comparing some of the characteristics of Xtreme’s rigs to Bryan Dunn’s quote, it is clear that Xtreme will likely be one of the first benefactors to enjoy increased rig utilization.

Coiled Services Division

Coiled tubing units have been utilized in oil fields for decades. Prior to the shale revolution, coiled tubing units were used primarily for well clean-outs, nitrogen kicks (stimulation of a well), matrix stimulation, and just about anything else the engineers could imagine up. To quote a Wikipedia article “Coil tubing can perform almost any operation for oil well operations if used correctly.” Since the rise of fracking, coil tubing has been primarily used for fracturing shale. Regardless of its use, from a 10,000 foot view, coiled tubing sends a long tube thousands of feet into the ground. This coil is wound on a large spool and fed into the well at a pre-determined rate (see graphic below). Like everything in oil and gas production, the goal is to get the job done as quickly and as cheaply as possible. Like everything in oil and gas production, things often go wrong.

Graphic 1. Coiled Tubing Unit Source: Xtreme Drilling [Website](#)



Keeping the tubing from getting stuck is a critical part to coil tubing jobs. If the tubing gets stuck, the operator loses money. Keep the tubing running and an operator has a better chance of making money. Xtreme has run more than 8 million feet of tubing in over 200 well [interventions](#) without a single incident of lost tools or cut pipe. According to management there have only been two incidents where their tubing was stuck.

Xtreme's coiled tubing solutions are saving money in other ways as well. In Saudi Arabia Xtreme has two XSR 200 Plus units [deployed](#). These rigs are being used to re-enter depleted wells and drill horizontally. They will extend the life of each well and increase reserves. The wells being re-entered are operating under negative pressure, thus the gas in the rock being drilled will flow out. The payback periods for these wells are very quick. Xtreme can [mobilize](#) up to 50% faster than traditional coiled tubing units and milling the reservoir (removing material from equipment or tools in the wellbore) can be done in a single bit run instead of two or three runs.

"By re-entering already existing wells in an unbalanced state, Aramco is able to drill laterally into the reservoir and then produce through the existing wellbore. In doing this, they potentially pay more upfront to do the coiled tubing drilling. However, it saves them from having to drill an entirely new wellbore and avoid a costly frac." – Charlie Proulx VP of Coiled Services Xtreme Drilling Quote Taken from drillingcontractor.org

From a technological standpoint, it is interesting that Baker Hughes chose Xtreme's [coiled tubing](#) units for their awarded Saudi Arabia work. Baker Hughes chose Xtreme despite the fact that Baker Hughes has an [active](#) Coiled Tubing and Reentry program. Presumably, Baker Hughes and Saudi Arabia went with Xtreme for both cost and quality purposes.

Currently, Xtreme's Saudi Arabia coiled tubing units generate around \$60,000 per day in revenue and operating expenses are roughly \$22,000 per day. In the United States coiled tubing units are only getting \$52,000 per day, with an expected low of \$46,000 per day this year. Operating expenses are \$30,000 per day in the United States. The higher operating expenses are due to the purchasing of tubing, whereas in Saudi Arabia the tubing is supplied. Given the better margins in Saudi Arabia, management is focusing on getting another coiled tubing unit to Saudi Arabia in the next 12 months.

Similar to land drilling, there is a bifurcation currently taking place in coiled tubing. Most coiled tubing is small (less than 2 inches in diameter). Smaller coiled tubing has less utility in the fields and large tubing is preferred. As expected, during downturns, better equipment becomes the dominant equipment and replaces old equipment. According to industry experts I spoke with, almost all of the coiled tubing currently being sidelined is smaller diameter tubing. Xtreme operates 2 5/8 inch diameter tubing providing an advantage in the current environment.

Re-fracking wells (sometimes called restimulation) is a potential area for Xtreme's coil tubing to pick up demand. Oil companies are looking for ways to increase their production and reserves at the lowest cost. Improved fracking techniques can result in a 30% [improvement](#) over initial flow rates when a well is re-fracked. According to [Wood Mackenzie](#), there are over 100,000 shale gas and tight oil wells that have been drilled in the past decade. Many of these are candidates for restimulation. Coiled tubing units would be ideal for these applications, especially units that are precise and utilize proven technology, like Xtreme's.

Ability to Survive

Xtreme has a rock solid balance sheet and can generate free cash flow, even in the current environment. As of March 31, 2015 Xtreme has about \$126.8 million of net debt and a current ratio of more than 2, providing ample liquidity for the company. Management fears excessive debt (in 2012 they had to issue 15 million shares at \$1.15/share to ease their debt burden) and believes it is critical to pay down debt. Conversations with management indicate that net debt will be around \$90 million by the end of 2015, implying at least another \$26 million of free cash flow for the last nine months of 2015.

Rig counts in the United States seem to have stabilized, although this rig count could go lower if oil decreases dramatically. The second quarter and third quarter of 2015 will likely be trough quarters for Xtreme, and perhaps the industry as a whole. It is encouraging that Xtreme can generate free cash flow even in an environment that sees rates drop by more than 30% and the idling of more than half of all U.S. based land rigs.

The bank will be happy that Xtreme can generate enough cash to cover interest expense and as a shareholder, I am happy to know that Xtreme will generate excess cash that can be utilized to pay down debt, buyback shares, or invest back into the business. Exactly how much excess cash depends on a few factors and a valuation needs to reflect that.

Valuation

Xtreme operates in a cyclical industry and therefore the company should be valued based on their earnings power through the cycle. I have constructed three scenarios for 2016 that estimate revenue for each segment and profitability. The estimates for free cash flow generation can be seen in the table below.

Table 3. 2016 Xtreme Revenue and Earnings Estimates. Sources: Author’s calculations and company financials

Scenarios	2016 Low	2016 Medium	2016 High
Land Drilling	\$101,944,500	\$123,789,750	\$143,335,500
Coiled Drilling	\$126,424,000	\$132,002,000	\$141,484,000
Consolidated Revenue	\$228,368,500	\$255,791,750	\$284,819,500
EBITDA Margin	21%	23%	25%
EBITDA	\$47,957,385	\$58,832,103	\$71,204,875
<i>Less Interest Expense</i>	<i>\$4,000,000</i>	<i>\$4,000,000</i>	<i>\$4,000,000</i>
<i>Less Taxes</i>	<i>\$9,600,000</i>	<i>\$9,600,000</i>	<i>\$9,600,000</i>
<i>Less Maintenance Capex</i>	<i>\$12,500,000</i>	<i>\$12,500,000</i>	<i>\$12,500,000</i>
Free Cash Flow	\$21,857,385	\$32,732,103	\$45,104,875
FCF/Share	\$0.27	\$0.40	\$0.55

My estimates encompass various utilization ranges and dayrates. The big assumption is that dayrates have at least stabilized for both segments. Given the rig count trends, I think this is reasonable. Therefore, a valuation would require valuing the company through-the-cycle based on the average of the three scenarios and seeing if the stock is undervalued at that point. The table below shows my estimates for Xtreme based on EBITDA and FCF multiples. The EBITDA multiple is an enterprise value multiple. Based on discussions with management, net debt will be around \$90 million by the end of 2015, which I subtracted from the enterprise value to arrive at the equity value in the EBITDA row.

Table 4. Valuation of Xtreme based on EBITDA and FCF

	Average	Multiple	Equity Value	Per Share Value
EBITDA	\$59,331,000	8	\$474,651,000	\$4.70
FCF	\$33,231,000	10	\$332,314,000	\$4.06
			Average	\$4.38
			Upside	80%

I believe an 8x EV/EBITDA multiple and a 10x free cash flow multiple are not demanding for a company like Xtreme. Perhaps a junior explorer with a limited operating history would command a lower multiple. The proven technology of Xtreme’s rigs/units and the conservative balance sheet provides logic for a higher multiple than true commodity names. As I believe the multiples are reasonable, I believe there is more than 80% upside to shares over the next 12-24 months. As debt gets paid down, and utilization stabilizes, Xtreme will continue to generate free cash flow.

There is upside though. I believe that Xtreme’s coiled tubing division is differentiated and should see continued demand, even if shale drilling fails to explode again. With the success seen in Saudi Arabia, Xtreme has partners that are fully funded through long market cycles and are willing to pay up for top equipment. As such, I believe there is a good likelihood that Xtreme starts to build new units prior to demand picking up. By my estimates, every new coiled tubing rig will add between \$3 million and \$6 million of EBITDA, most of which should drop down to the bottom line as free cash flow.

With a conservative 5x multiple applied to average EBITDA of \$3.75 million, each rig is worth roughly \$22.5 million to enterprise value. Each rig will require little, if any debt, and thus most of the implied enterprise value should flow down to equity. The table below shows some sensitivity for varying dayrates.

Table 5. Value Add for new Coiled Tubing Rigs Source: Dichotomy’s Calculations

	Low	Mid	High
Day Rate	\$45,000	\$57,000	\$63,000
EBITDA	\$3,000,000	\$3,900,000	\$5,100,000
EBITDA Multiple	5X	5X	5X
Enterprise Value	\$15,000,000	\$22,000,000	\$30,000,000

Even if you believe the multiple is off, it is not hard to see that coiled tubing units are very accretive at current construction costs of \$6.5 million (per management). Deployed in a prudent and rational manner, shareholders could see significant upside upon any resumption of a newbuild coiled tubing program. The table below estimates value to equity assuming that \$3 million of a new unit’s cost is financed with debt. Thus if a rig costs \$7 million, Xtreme would finance \$3 million and use \$4 million of equity, which could likely be funded via cash flows from existing units. The scenarios are based off of Table 4 above for the “Low”, “Mid”, and “High” calculations.

Table 6. Potential Equity accretion for New Coiled Tubing Units

New Coiled Tubing Units	Low	Mid	High
1	\$12,000,000	\$20,400,000	\$27,600,000
2	\$27,000,000	\$43,800,000	\$58,200,000
3	\$42,000,000	\$67,200,000	\$88,800,000
4	\$57,000,000	\$90,600,000	\$119,400,000

Obviously, this all assumes that they can find work for each newbuilt rig. In today’s environment it does not make sense to build rigs under some Potemkin view of the market. I present the possible equity accretion to highlight what could happen in a stronger environment and the upside present. If an investor believes the “Mid” scenario is likely for Xtreme, a single new coiled tubing unit could be worth more than \$0.25/share.

Risks

There are a number of risks with Xtreme, but the two biggest, in my opinion, are technological obsolescence and sustained low oil prices. As this is being written, Xtreme has land drilling rigs that are considered some of the best and coiled tubing units that are second to none. Technology changes fast though and Xtreme’s equipment could soon be considered second tier if new advances arrive.

For example, Xtreme currently purchases their coiled tubing from Global Tubing. Industry experts I interviewed had nothing bad to say about Global Tubing, but they were excited about Tenaris’ Blue Coil. Blue Coil utilizes a different manufacturing technique to create a single strand of coil, rather than multiple pieces welded together and reinforced at the joints. While the coil is more expensive upfront, the coil does not have structural weakness (near welds) and instead enjoys consistent strength throughout the length of steel.

Blue Coil has not been field tested yet, so it remains to be seen how well it actually works when put to the test. I present Blue Coil as an example of rapidly changing technology in the oil business, where the best technology can quickly become obsolete. This is clearly a risk to Xtreme.

The second risk, sustained low oil prices, is fairly obvious. Lower prices leads to fewer wells drilled and fewer wells completed. This would impact utilization rates for Xtreme’s drilling rigs, and probably their coiled tubing units.

Finally, management could jump the gun and try to build new units prematurely. This poor capital allocation decision cannot be eliminated and will be watched for closely.

Conclusion

Xtreme Drilling offers a compelling valuation in the oil sector. While the company lacks the tremendous upside many junior oil names carry, it also has protected downside thanks to their industry best coiled-tubing units, Tier 1 drilling rigs, and a solid balance sheet. The company has generated plenty of free cash flow throughout the cycle including now, in what may be a trough environment.

Management understands the name of the game is to survive right now and I believe their balance sheet and cash flow generation will allow them to not only survive, but prosper. Purchasing shares today allows investors to participate in any sort of oil recovery. If oil prices stay low for an extended period, management intends to pay down debt, which will accrete back to shareholders. Given the strength of the balance sheet and the technology, I think Xtreme is an attractive purchase for a larger company like Baker Hughes, Superior Energy Services, or any other international oil services company that wants top tier technology.

I believe that shares of Xtreme have at least 80% upside under conservative scenarios and should oil recover in any meaningful way, shares could appreciate significantly more.

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