SECURE ENERGY (SES-TSX)

Most investors don't understand the COLOSSAL amount of **<u>water</u>** the oil and gas industry produces—about 115 billion barrels of oil per year, or 3:1 vs the oil that comes up. In the US it's now 8:1, and forecast to grow to 12:1 in the coming years. And it's only getting bigger as we go deeper in the ground and through longer horizontal wells. Water is one of the Biggest Themes of the global energy patch.

It's also one of the most emotional—witness the fracking vs. groundwater debate. That leads to more regulation. Combine these two themes—more water and more regulation of it—and it becomes simple to understand the growth path in Secure Energy Services.

They have a cradle-to-grave strategy for handling water in the energy patch—from drilling through to production through to well abandonment. And they have executed incredibly well, growing through acquisition and organically from almost zero to $350 million in cash flow in just five years.

That's why the stock is NEVER cheap. When I bought it, Secure was trading at 1.5-2x its peer group averages.

But I like expensive stocks—they are able to use their stock as currency to make accretive acquisitions. There are other trends happening in the oilpatch that help Secure:

1. More horizontal wells

2. Deeper and longer horizontal wells

3. Stricter environmental controls on fluids and solids handling of the materials used in horizontal wells (FRACKING fluids, water – this part of the industry is only going to get bigger, which means....

4. More producers will farm out this task as a specialty service, just to get rid of the environmental liability

The only thing that Secure Energy is missing is some sort of technological advantage (ie. Patent) that puts up a barrier to competitors entering the business.

That means that Secure Energy has to provide high quality and low cost service in order to thrive.

The financial results (33% per share EBITA growth) tell us that Secure Energy is doing just that.

QUICK FACTS

Trading Symbols:	SES-TSX
Share Price:	$13.96
2012 Revenue:	$1,029 million
2012 EBITA:	$99.6 million
Shares Outstanding:	104,894,000
Market Cap:	$1,373 million
Net Debt:	$168 million
Enterprise Value (EV)	$1,541 million
Dividend	$0.15, paid monthly at $0.0125 (1.1% yield)

http://www.secure-energy.ca/

POSITIVES

-early innings of the horizontal oil and gas drilling boom in Western Canada

-the LNG drilling boom has barely even gotten started

- higher North American oil prices should lead to increased spending by producers

-environmental standards are only going to get more strict and companies will need to spend more on waste & water disposal

- richly valued shares allow the company to repeatedly make accretive acquisitions

-trend toward long horizontal wells with more fracture stages continues

-the amount of water produced in the WCSB has increased by 8% per year since 2000 and that rate is going to increase

NEGATIVES

-there isn't a large moat (technological edge) around this business so the key to success involves top notch execution (providing a low cost and high quality service)

-commodity price risk, lower oil and gas prices means less drilling by producers

-environmental movement slowing the fracking revolution

- rich valuation means that shares could drop a long way (multiple compression) if growth falters

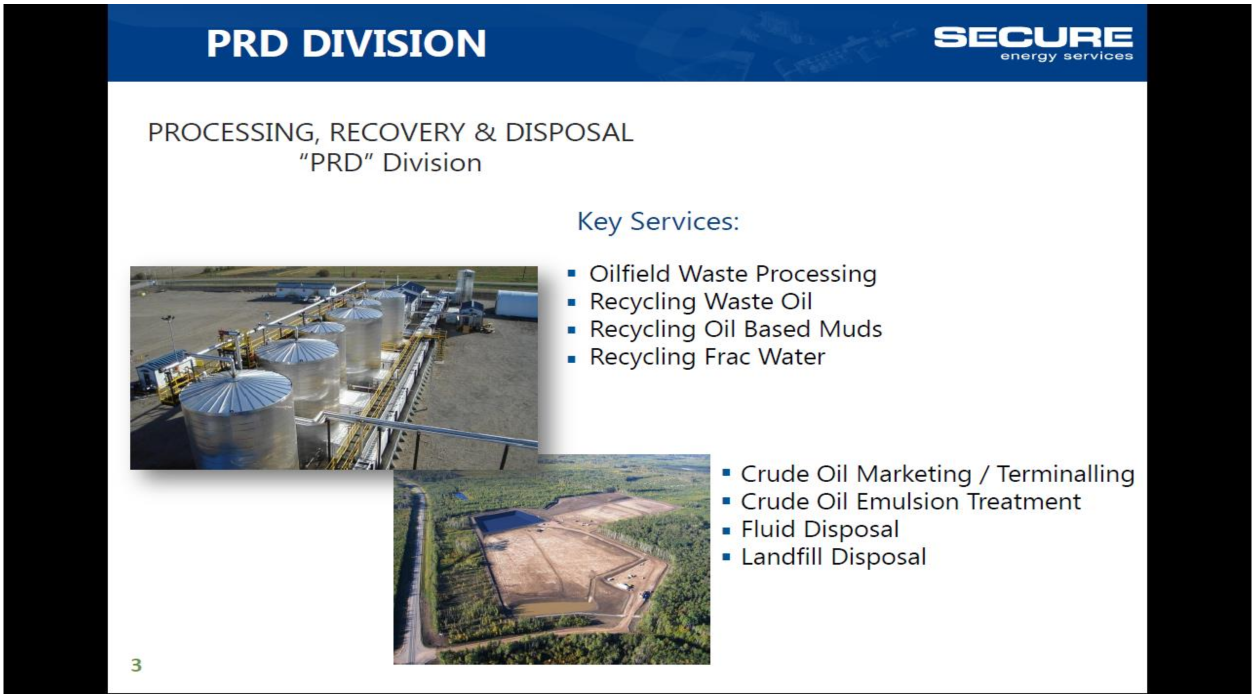
-There are plenty of horror stories of acquisitions gone wrong, so there is risk of a bad purchase impacting the business in the future

THE BUSINESS

Secure doesn't just treat water—it treats oil, and all the garbage that comes up with oil—solids like drill cuttings, rock, and the dirt that's in the oil. They clean all that gunk and get rid of it back downhole in a licensed and regulated SWD—SaltWater Disposal Well

First let's talk about how they clean and sell oil for producers. They call this the PRD division, for Processing, Recovery and Disposal.

<u>Division 1 - Processing, Recovery and Disposal</u>



Oil has to be cleaned before it can be put in a pipeline. Secure does that at their Full Service Terminals, or FSTs. If the FST is hooked up to a pipeline, the cleaned oil can be either stored in tanks or sent right into the pipeline. If the FST is not attached to a pipeline, the oil is trucked to Secure's nearest FST that is hooked up to a pipeline.

The contaminants are then stripped out and the water – often full of salt - is sent down into a disposal well and the other waste solids are put into a Secure landfill. Every FST has a disposal well (or SWD facility).

Producers will also transport other fluids like the drilling mud, and the fracking fluids, to the FST to be treated, stored and disposed of, and the tanks in which they came get washed out. They also go down a deep disposal well.

Two-thirds of the PRD services revenue is tied to production related activities and not drilling/completion work. This is good because production revenue is consistent and predictable while drilling/completions is cyclical.

The market pays a higher multiple for this kind of revenue and cash flow.

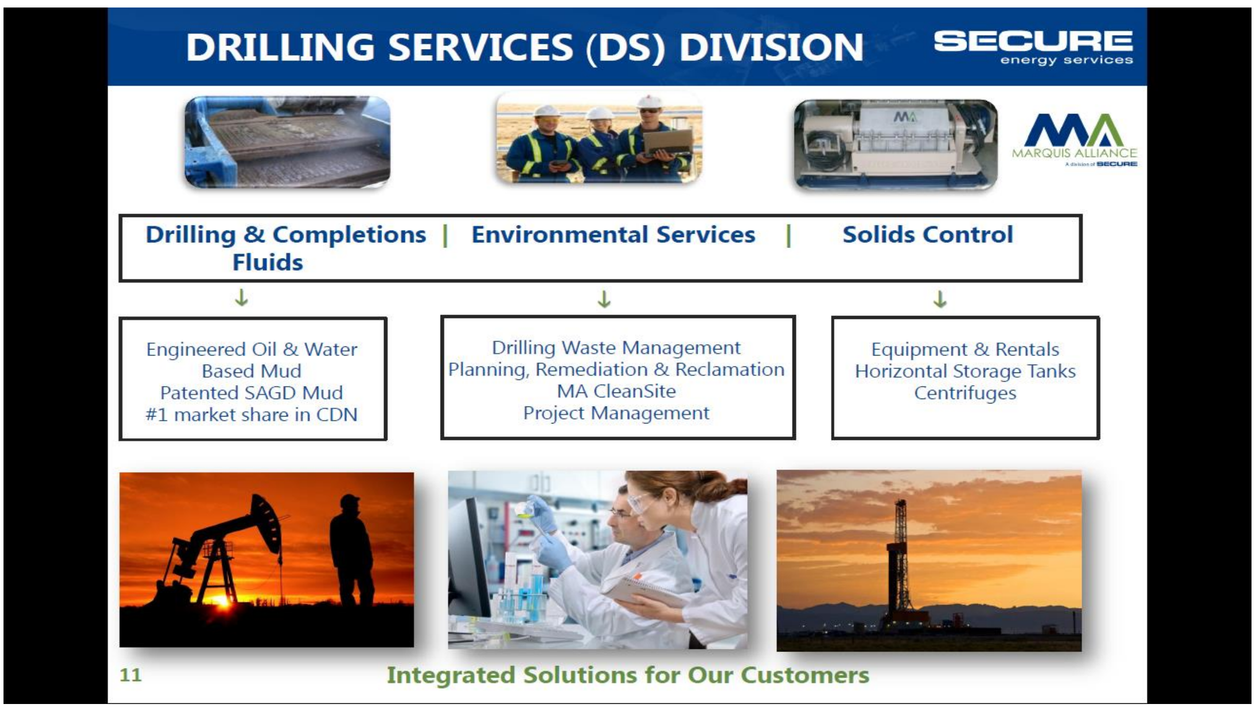
Not only is the volume of production revenue consistent, so are the prices Secure charges.

Again, more consistent and more predictable means a higher valuation from the market.

PRD Service Line #2 - Oil purchase/resale service:

Sometimes Secure just buys the oil from the producer and looks after it right as soon as it hits the FST. That not only helps provide a one-stop shop, Secure can usually create a better cleaner blend of oil and realize a small uplift in quality and price—which they get to pocket. That is very smart business and one of the main *reasons they have the best margins of any energy services company in Canada.*

Division 2 – Drilling Services



Secure's Drilling Services Division operates through its wholly-owned subsidiary, Marquis Alliance. They compete directly with another OGIB stock pick, Canadian Energy Services.

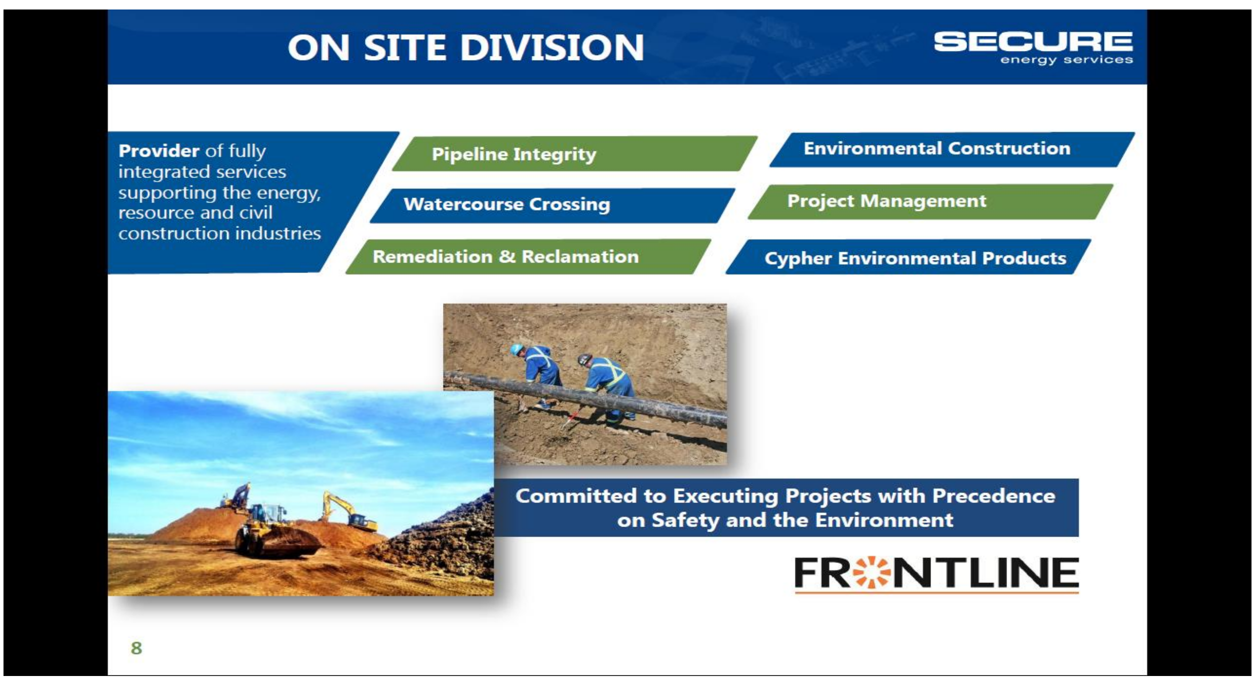
Drilling fluid is a high margin, high growth business that is not capital intensive. The Shale Revolution means more water/fluid is used And as wells get deeper and longer, they'll use even more water. This is where Secure is focusing its efforts.

Drilling fluids are used for:

- cleaning debris out of the hole,
- stabilizing and sometimes strengthening the formation drilled,
- controlling subsurface pressures,
- enhancing drilling rates
- protecting potential production zones while conserving the environment in the surrounding surface and subsurface area.

The Drilling Service Division also has a solids control (seperates solid material from drilling fluids) equipment rental service line—used mostly in the oil sands—and an environmental services area that helps producers get rid of waste water.

Division 3 – On Site Division



The business provides services relating to pipelines and includes inspection, repair, excavation and demolition. It's meant to support and add onto the services offered by the Drilling Services Division.

FINANCIALS

Secure has experienced rapid growth over the past three years. Revenue and EBITA for each year are below:

	2012	2011	2010
Revenue	1,029,440,000	551,199,000	72,993,000
EBITA	99,600,000	62,000,000	22,269,000

This growth is both internally generated as the company builds new facilities, but also to a large part because of a very aggressive acquisition strategy. Over the past two years alone the company has made the following acquisitions:

Date	Transaction	Price	Description
June 2011	Marquis Alliance	$131 million	Establishes drilling service division
July 2011	XL Fluids	$40 million	Addition to drilling service division
Oct 2011	Silverdale	$18 million	Processing facility
Jan 2012	New West	$4 million	Drilling fluids company
July 2012	Saltwater	$26 million	Bakken water disposal
Aug 2012	Drilling Fluids	$7 million	Drilling fluids company

The rich valuation that the market has typically assigned to Secure Energy's stock has been a great advantage and allowed for these acquisitions to be accretive for shareholders.

And those accretive acquisitions show up in growth on a per share basis. EBITA per share for each of the last three years looks like this:

2010 - $22.2 mil / 63.7 million shares = $0.35

2011 - $62.0 mil / 90.2 million shares = $0.63

2012 - $99.6 mil / 104.6 million shares = $0.84

That is a healthy year on year growth rate on a per share basis.

A balanced approach of using both equity and debt for growth has left Secure with $144 million drawn on a $300 million credit facility that matures July 31, 2015. That leaves the company with lots of liquidity. With EBITA for the trailing twelve months of $107 million Secure has a Debt to EBITA ratio of 1.57 times—the sweet spot; more than 2x is frowned on.

FINANCIAL RESULTS

SECURE energy services

Six Months Ended June 30, 2013 Comparison*	YTD 2013	YTD 2012	% Change
PRD Division Revenue**	80,318	57,480	40%
Drilling Services Division Revenue	134,251	117,180	15%
Onsite Services Division Revenue	18,083	9,673	87%
Total Revenue	**232,652**	**184,333**	**26%**
Operating Expenses**	150,415	118,243	27%
G&A Expenses	24,436	17,953	36%
Business Development Expenses	3,939	1,789	120%
Total Expenses	**178,790**	**137,985**	**30%**
EBITDA	**53,862**	**46,348**	**16%**

* All amounts in thousands

** Excludes oil purchase & resale.

VALUATION

Secure is a fast growing company operating in an industry (and region) with tremendous growth prospects for the next decade—that's one reason why the stock is not cheap. That is what rapid growth does for you. A growth stock never looks cheap using standard valuation measure and likely never will as long as it keeps growing.

That is because rapid growth quickly makes what initially appears to be a richly valued stock very cheap over time.

Secure is currently trading for 15 times 2012's EBITA. That looks expensive.

But you could have said the same thing in 2010 and missed out on some big returns.

In 2010 Secure had EBITA of $22 million. If in 2010 Secure was trading at 15 times EBITA it would have had an enterprise value of $330 million. Today an enterprise value of $330 million is barely more than 3 times what EBITA will be in 2012.

Secure Energy didn't look cheap in 2010. But thanks to the rate of growth it has experienced it actually was.

That is why I love growth stocks. Valuation matters, but growth matters more.

Of course there is risk involved when buying growth stocks. Investing in growth stocks is hugely rewarding as long as the growth continues. If that growth goes away, then we have problems.

If the growth stops that rich multiple will quickly get cut in half by the market, which of course also cuts the stock price in half.

Because of the industry trends mentioned earlier I think Secure Energy Services has years of growth ahead of it.

WHAT THE ANALYSTS SAY

STOCK CHART

CONCLUSION

The business that Secure Energy operates in offers direct exposure to the virtually certain continued growth in horizontal drilling, the trend towards longer horizontal wells and the coming LNG boom in Western Canada.

Over three years this company has gone from $70 million in revenue to over $1 billion. Hard assets underpin growth; and per share growth has also been strong. It’s rare to find a management team that executes as well.