Civeo, a provider of remote-location accommodations to the oil services and metallurgical coal industries, is generating a lot of questions these days, trading at a price that seems to reflect a significant bankruptcy risk. This perception is understandable considering the company's net debt of more than $350 million and the lack of GAAP earnings for a number of years. However, these observations fail to capture some important characteristics of the company that are material to its investment thesis.

The first item to note is that Civeo generates significant free cash flow despite its negative stated GAAP earnings. This is due to substantial non-cash depreciation charges for lodges built a number of years ago, but for which there is little ongoing maintenance expense. There have also been periodic impairment charges for these assets that must be taken when business slows, regardless of what the future prospects for these assets might be. To place these numbers in context, Civeo reported negative earnings of $60 million in 2019 and had depreciation expenses of nearly $124 million and impairment expenses of $26 million. As a result, the company recorded cash from operations of nearly $75 million for the year.

Going forward, a large portion of the cash being generated can be used to pay down debt. This may not be obvious to casual observers, considering that net debt was relatively unchanged through the first three quarters of 2019 while the company invested in growth projects. However, these investments have been completed and the company was able to reduce debt by nearly $35 million in the fourth quarter. Ongoing capital expenditure requirements are negligible and, as a result, the vast majority of cash from operations, conservatively estimated to be $60-$70 million per year, should be available to retire debt. As a reminder, the entire market capitalization of Civeo is less than $70 million today.

Clearly the company will continue to generate free cash flow so long as revenues do not deteriorate. However, this begs the question: what are its business prospects going forward, especially with oil trading at $20 a barrel? There is no clear answer to this, though there are reasons to believe that Civeo will continue to generate sufficient cash to survive the current environment and retire debt at the rate of approximately $50-$60 million per year, compared to its free cash flow forecast for 2020 of $60 million. If they were to achieve this, debt would be a very manageable 2x EBITDA by the end of 2021, when they will need to refinance all of their outstanding obligations.

One must remember that Civeo's business in Australia, which represented 30% of revenues in 2019, is not tied to oil services at all. It serves the metallurgical coal industry, which, frankly, was only beginning to recover from the doldrums it has been living through for a number of years. Today, Australian coal is about $67/metric ton compared to over $100 in 2017, so it seems a further recovery might now be on hold for the foreseeable future. Despite this, the downside to the existing business seems limited.

The business in Canada, which accounted for more than 60% of revenues last year, can be divided into two categories: new contracts related to LNG infrastructure projects, and legacy business related to the oil sands industry. The LNG business is contracted for a number of years into the future and ensures that, at a minimum, the company will recoup its capital expenditures and earn a modest return on investment. In fact, approximately 25%-30% of consolidated revenues are guaranteed under take-or-pay contracts, with total contracted revenues (LNG or otherwise) for 2020 totaling $140 million compared to total revenues of $528 million last year. Furthermore, the oil sands industry, which is vital to Canada's economy, is not likely to meaningfully reduce production at these prices. This is because the expenses required to get an oil sands operation into production can be significant, but, once it is running, ongoing expenses are relatively low. Suncor, for example, which is one of Civeo's largest clients, has said that it expects cash costs at today's prices of $18-$20 per barrel for 2020. Because of this, companies may prefer to operate at break-even, or even temporarily lose money at current prices, as opposed to shuttering operations and having to spend significantly more to restart production.

For these reasons, it is reasonable to believe Civeo will survive the current market. If it does, the potential upside is many multiples of the current share price.

One way to measure a base case scenario is to make some simplifying assumptions. This need not be a prediction, it's just an efficient assessment tool; assumptions can always be adjusted. Should activity levels in the Canadian oil sands remain unchanged, the company should generate $60 million of free cash flow per year, with significant upside to this estimate if markets begin to recover. It is reasonable to believe that this will be the case, as there is a large portion of the energy sector with higher cash costs than the oil sands producers, and these companies will be the first to curtail production. It is also exceedingly unlikely that oil prices remain at $25, given the significant underinvestment in the energy sector over the last number of years. Even last year, Chevron, by choice, replaced only 44% of the reserves it sold, because it did not anticipate an adequate return on exploration expenditures at the roughly $50 level of the past few years (other than for some particularly productive areas, such as the Permian Basin in Texas). So global supply was already being reduced. This is the way oil – and gold and other commodity markets – has always worked. The repercussions of this present collapse in oil prices, once production has been taken off line and global business activity resumes, could be an equally distressing oil price shock *upwards*. As recently as 2018, oil was $75, and in 2014 it exceeded $100.

Accepting last quarter's results simply as a normalized level for the purposes of this exercise, Civeo could retire all of its debt within six or seven years. At that point, it would be debt free and generating approximately $80 million in free cash flow (the $60 million run-rate free cash flow plus the $20 million it would save in interest expense, assuming no cash taxes, care of its large net loss carryforwards) per year. If one attached a modest multiple of 10x to this figure, the stock market value would be $800 million, or $4.71 per share. This is not a growth or success scenario valuation, but a steady-state scenario.

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