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'Big passion project'

Evan Lorenz writes:

The prices of crude oil and natural gas have gone their separate ways for more than a decade. For the most part, oil has been rising and gas falling, such that, nowadays, gas trades for less than a quarter of the equivalent-energy content of West Texas intermediate. Following is a bullish look at New Fortress Energy, LLC (NFE on the Nasdaq), a high-risk, still early-stage arbitrage play between the two energy sources.

Natural gas has the environmental bonafides that other fossil fuels lack. Burn a million British thermal (MMBtu) units of bituminous coal, and you spew 205.7 pounds of carbon dioxide into the atmosphere. Burn the like amount of diesel, and you produce 161.3 pounds of CO_2; of natural gas, only 117 pounds.

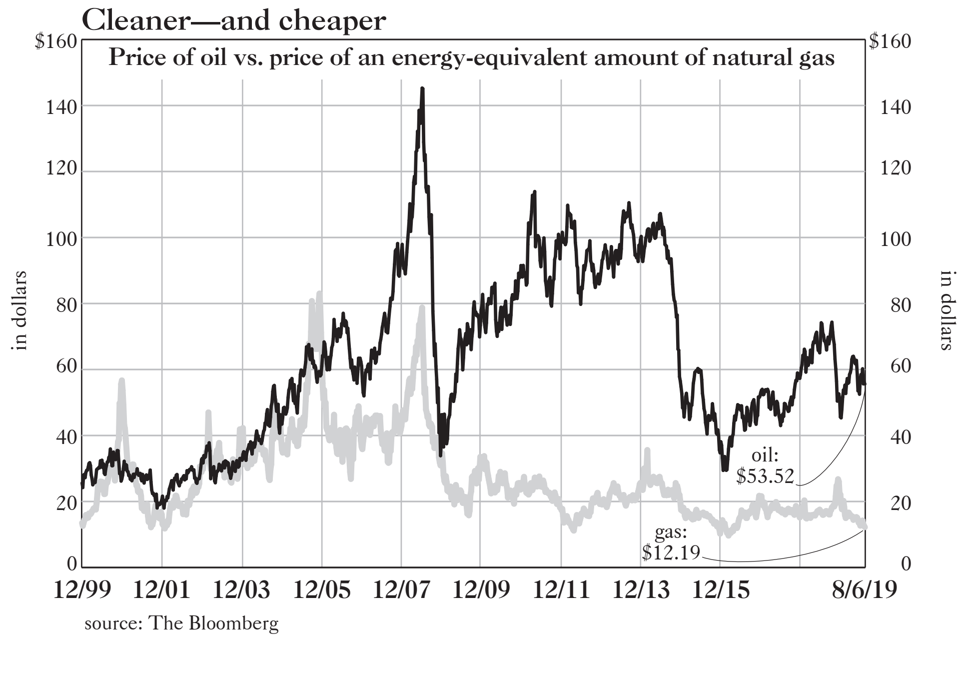
Natural-gas-fired plants, which can cycle on and off more quickly than other fossil-fuel-fired means of generation, pair well with intermittent renewable-power sources like solar and wind. And when you chill gas to 260 degrees Fahrenheit below zero, methane condenses by 600 times to form liquefied natural gas (LNG), a commodity that can be loaded in ships and dispatched around the globe.

Historically, natural gas and oil have traded near the same energy-equivalent price. This relationship began to break down in 2006 and collapsed in the years following as prodigious shale wells flooded America with gas. The genesis of New Fortress Energy is the long-term chart of oil vs. natural gas: Wes Edens, the CEO and chairman of NFE and the co-CEO of Fortress Investment Group, tells me that he printed a copy of that chart in 2012 and started to carry it around with him. In 2014, Edens found a way to capitalize on the dislocation. He decided to run the Florida East Coast Railway, a Class II rail in Florida then owned by Fortress, on liquefied natural gas instead of diesel.

"One small problem on the way was there was no liquified natural gas in Florida," Edens recounts. "Not a drop of it. We went and talked to a couple of oil companies and said, 'This is a great opportunity. Why don't you build a liquefier? We have space for it, and we'll buy a big chunk of your offtake.' They said, 'If you buy 100% of our offtake for the next 20 years, we will build it for you.' I said, 'Looks like we are going to build our own liquefier.'"

So Edens founded NFE with the goal of doing exactly that. In 2016, New Fortress Energy completed construction of a small liquefier in Miami with 100,000 gallons of capacity per day at a cost of around $70 million. The switch to LNG cut Florida East Coast's fuel expense by 25%.

The problem that Edens faced in 2014 persists today: Oil and gas companies are happy to create the infrastructure for large customers who agree to take 100% of targeted production, but smaller customers who can't make those commitments find no such welcome mat. This is especially a problem for the many economically striving nations that burn dirty and expensive diesel or heavy fuel oil to generate electricity. New Fortress is targeting those customers and is supplying both the infrastructure and



the logistics to effect the conversion to natural gas.

In October 2016, in Montego Bay, Jamaica, NFE built a regassification facility capable of processing 740,000 gallons of LNG per day and storing up to 7,000 cubic meters on site. The primary customer: a 145 megawatt power plant operated by Jamaican Public Service Company Ltd. JPS agreed to take only approximately 300,000 gallons per day, but some smaller industrial customers, including the Red Stripe brewery, committing to an additional 159,000 gallons per day, have signed on as well.

"The import facility at Montego Bay is presently servicing seven customers, by both pipeline and truck," Jonathan Chappell and Sean Morgan, who rate NFE a buy at Evercore ISI Research, advised their clients in June. "And the mid-six-figure annual savings and cleaner operating environment from one of the customer plants we toured is already leading to reverse inquiry [i.e., customers asking NFE for service] from other businesses looking to share the same financial and environmental benefits. We know we are financial analysts and the mid-six-figure savings certainly resonates with us, but to see smokestacks in full operation with no visible output from LNG (versus black smoke from diesel) is a remarkable takeaway."

It is also notable that NFE completed the Montego Bay project just 14 months after signing the contract, in August 2015. "We are like Apple, designing and integrating parts, and the supply chain is modular, standardized, scalable and, most importantly, industrial," says Brannen McElmurray, the chief development officer of NFE. "If you think about a terminal, it has systems and parts and pieces. What we are doing is coming up with modular concepts that can be built in a fabrication facility in Louisiana or Minnesota, and they come to site, [they] skid it up and effectively put [them] together like Lego blocks. From the time you say you want it, the goal is to deliver it 12 months later."

NFE's corporate pitch to a Caribbean customer is simplicity itself: $12 per MMBtu of gas vs. $18 per MMBtu of diesel. There are other benefits, too: Diesel bought for power plants in emerging markets often suffers what is known in retailing as "the shrink" and what the power-plant aficionados describe as "non-technical losses." The worst kind of diesel thieves replace the fuel they take with foreign substances that can shut down a power plant. So add to the list of LNG's advantages that criminals can neither burn nor haul it.

New Fortress's costs, including purchasing and transporting the gas and the cost of infrastructure, is around $7.50 per MMBtu, which produces margins on the order of 38%. Clearly, there are substantial profits to share for both the customer and the company.

The Montego Bay terminal has proven a blessing for the Jamaican economy, a fact duly reflected in Moody's November 2016 upgrade of the island's sovereign-credit rating to B3 from Caa2. According to the International Monetary Fund, Jamaica's current account deficit will dwindle to 2.3% of GDP in 2019 from 7.4% in 2014 thanks both to the move to LNG and to the drop in oil prices.

Based on commodity prices as of May 14, NFE estimates that customers save between $80 to $90 million a year for every 100 megawatts of capacity switched to LNG. The JPS plant in Montego Bay is rated at 145 megawatts, indicating a saving of as much as $130.5 million, no small thing when the country's GDP last year was $15.4 billion.

New Fortress is building three more terminals (in Old Harbour, Jamaica; San Juan, Puerto Rico; and La Paz, Mexico), a pair of power plants (Old Harbour and La Paz) and a liquefaction plant (Wyalusing, Pa.). The M.O. is to build more capacity than its principal customer can currently use while trusting that future demand from new customers will absorb the rest. Across four terminals, as of March 31, NFE has contracted volumes of 2.5 million gallons per day, up from 960,000 gallons the prior year.

To be clear, New Fortress is still a profitless, formative-stage business—widows and orphans, please be advised. The first quarter brought a net loss of $60 million, of which about half pertained to expenses relating to the company's initial public offering.

New Fortress line personnel get high marks for experience, a fact that mitigates (though, of course, cannot erase) the significant development and execution risks. "I have been very impressed with their knowledge of the industry and with their CVs," says Chappell. "A lot of these guys have come from the oil and gas industry and have a very good understanding of the business model. They are not just financial guys who are plugged and placed to try and make this work. I think the team is very good from top to bottom."

As of March 31, New Fortress had drawn down $488.3 million of its $500 million loan facility and showed $359.5 million in cash on hand. CFO Chris Guinta told analysts on the May 15 earnings call that the company is arranging a loan of up to $225 million secured by the 150 megawatt power plant now being built in Old Harbour.

"If you take that combined with the cash on the balance sheet, you have all the capital you need to build out the four terminals we have today," Guinta explains. "That includes the two terminals that are complete, the terminal in Puerto Rico, plus the terminal and the power plants in La Paz and Old Harbour. All of those things are funded. At that point in time you will be cash-flow-positive even after debt service and capex, $200 million plus of free cash flow." That would give the stock a 10% free-cash-flow yield excluding the liquefaction plant under construction in Pennsylvania. Even so, New Fortress will need additional financing to finish its $800 million liquefier, of which, as of March 31, just $50 million had been spent.

Of course, NFE's value proposition isn't graven in stone. It would dim considerably if oil and natural gas again traded at parity on an energy-equivalent basis, though natural-gas producers seem to see little risk of that. Thus, to supply the Pennsylvania liquefier, which is expected to begin operations in 2021, NFE has signed a 15-year supply agreement with Chesapeake Energy Corp. at prices generally fixed at $2.50, equivalent to an oil price of $14.50 per barrel.

While the future may look bright, the recent past has been nothing to write home about, at least as far as equity value is concerned. New Fortress listed its shares on Jan. 30 at $14 apiece, down from initial talk of $19; today's quote is $11.52. "It was a hard time to raise money, but they have a lot of projects and needed to be able to move forward on this," says Ben Nolan, who rates NFE a buy for Stifel.

On top of the rocky start to public trading, the oil and gas industry generally is in a funk. As a proportion of the S&P 500, energy companies have slumped to just under 5% from almost 11% in 2014. A cool start to the summer caused American gas in storage to soar 14% year-over-year to 2.6 trillion cubic feet as of July 26, according to the Department of Energy. Year-over-year, the gas price is down by 26%.

If possible, things are even worse outside the 50 states. Royal Dutch Shell plc, which accounts for around one quarter of all LNG traded worldwide, last Thursday reported a 23% slump in second-quarter results, driven by a 25% decline in the gas division's earnings. "What we are seeing this year is the confluence of both the startup of new LNG-producing facilities coming on the heels of a weak winter," CEO Ben van Beurden complained to Bloomberg TV after the announcement.

A warm Asian winter coupled with waning demand in South Korea and Japan pushed down LNG prices by around 40% in the second quarter, but bad news for the energy industry is not necessarily bearish for NFE. Indeed, other things being the same, the lower the cost of LNG cargoes, the greater the profit for New Fortress.

Squinting into the future, the Street projects 2022 earnings before interest, taxes, depreciation and amortization on the order of $561 million, but the analysts credit the company only with projects finalized with signed contracts. To the extent that NFE can sign additional contracts and successfully deliver its pipeline of projects, analyst estimates could prove conservative.

To complete its current slate of projects, NFE will have to draw down fully its loan facility and incur additional borrowings, so let's pencil in net debt of $1 billion. At the current share price of $11.52, NFE's market capitalization totals $1.9 billion. If the analysts are on the beam, NFE would be changing hands today at 5.2 times enterprise value to 2022 Ebitda. If shares re-rated to an eight-times multiple, low for infrastructure investments, NFE would be worth $20.77 a share in three years.

Of the seven analysts on the case, five rate the stock a buy, none a sell. Owing to a 180-day lockup following the IPO, executives were barred from sales through July 29, but nothing prevented them from buying. Wes Edens and Randal Nardone, a NFE director and co-founder and principal of Fortress Investment Group, each bought 2.5 million shares at the IPO. They have subsequently purchased an additional 1.4 million shares in the open market. Prior to the offering, Edens and Nardone funded NFE with their own cash. The pair owns 147.1 million non-traded, class-B shares valued at $1.7 billion. (The class-B shares confer 10 votes but do not accrue any economic rights, i.e., dividends. They are exchangeable on a one-for-one basis with the class-A shares held by the public.) This is material to Edens's net worth, which *Forbes* estimates at $2.5 billion.

"This is the dominant thing I do," Edens tells me. "It's a big passion project in terms of the impact on people and places in the world. It's the best business that I've ever been a part of. If you said you had a business with 40% margins that has significant barriers to entry, that has virtually inexhaustible demand, that is pretty attractive—and that is what this is."

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