

Free Cash Flow

Three of the past four quarters for Petrohawk have produced negative free cash flows (FCF).

In thousands

	Q4 2007	Q1 2008	Q2 2008	Q3 2008
EBITDA	161,238	165,366	248,287	247,270
Less: Cash Taxes	2,589	-34,683	-57,273	118,639
Less: CapEx	197,538	150,405	1,243,702	1,151,837
Less: Inc. in NWC	-27,839	-5,352	-175,958	130,932
Free Cash Flow	-11,050	54,996	-762,184	-1,154,138

Free cash flow was significantly impacted by high capital expenditures, forcing free cash flows negative for the first three quarters of 2008. In aggregate for FY2008 we expect free cash flows to be negative by \$1.9 billion, with \$20 million coming in the fourth quarter.

FCF should rebound modestly into positive territory in 2009. Increases in production capacity will drive EBIT higher, and management has committed to cut the capex next year to \$1 billion,¹ which will boost FCF.

Financial Leverage

With approximately \$1.8 billion in long term debt outstanding, Petrohawk's debt-to-book equity ratio of 0.46 is in line with the industry average of 0.47.² Using the market value of equity, on a fully diluted basis, Petrohawk's financial leverage is slightly lower, at 0.36.³

Leverage on Existing Debt	
Debt/Book equity	0.46
Debt/Market equity	0.36

In a press release issued on Jan. 22, 2009, Petrohawk announced its intention to place \$300 million in senior notes. The company planned to use the proceeds to "repay a portion of the outstanding borrowings under our senior revolving credit facility."⁴ In addition, surplus funds were expected to be directed toward acquisitions, infrastructure expansion and working capital needs.

¹ Petrohawk Energy. 10-Q filed 11/6/08, pg. 24.

² MSNMoney. Key Ratios: Industry Avg. Debt/Equity Ratio. www.moneycentral.msn.com. Accessed 1/27/09.

³ HK stock price of \$19.71 as of 1/30/09.

⁴ Petrohawk Energy. News release issued 1/22/09. <http://www.petrohawk.com/news/?id=1247150>. Accessed 1/27/09.

The next day, on Jan. 23, Petrohawk published another press release informing investors that it had priced a \$600 million offering.⁵ Based on the new – and heavier – debt load, Petrohawk's debt-to-book equity ratio rose above the industry average to 0.62.

Leverage with New \$600M Debt	
Debt/Book equity	0.62
Debt/Market equity	0.48

Management anticipated the yield to maturity (YTM) on the new debt would be 12.75%, with a 10.5% coupon.⁵ The current YTM on Petrohawk debt is 11.2%, and the debt rating, according to Moody's, is BBB.⁶

Price to Earnings

Based on our EPS estimates for 2008 and 2009 of \$0.60 and \$0.40, respectively, Petrohawk's P/E ratios are high compared to comps.³ Furthermore, its earnings yields for 2008 and 2009 are substantially lower than what Petrohawk's bonds are currently yielding.

	2008	2009
Earnings per share	0.60	0.40
Price to earnings (P/E)	32.9	49.3
Earnings yield (E/P)	3.0%	2.0%

Despite a higher yield on debt, we believe HK's equity has a more attractive risk/reward profile. We consider the upside potential of HK stock to be 13% to 20% over the next two to three years as investors recognize the inherent value in Petrohawk's equity and as oil and gas prices rebound from their current troughs.

Recommendation

For long-term investors we recommend purchasing Petrohawk's equity. The company has invested significantly to increase future production, and we expect oil and natural gas prices to trend higher over the next several years. The net effect will be an increase in HK's bottom line and considerable bump in cash flow.

⁵ Petrohawk Energy. News release issued 1/23/09. <http://www.petrohawk.com/news/?id=1247700>. Accessed 1/27/09.

⁶ Bloomberg Terminal. Accessed 1/30/09.