

EMERGE ENERGY SERVICES IS POISED TO DROP 50% ON THREE POSSIBLE NEGATIVE CATALYSTS

November 11, 2015

RESEARCH SUMMARY

- Emerge Energy Services (EMES) had an atrocious 3rd quarter and is a bankruptcy risk. We have a \$2.50 price target on the stock.
 - There are three possible upcoming negative catalysts for EMES: 1. The amendment of its credit facility 2. The start of an ATM equity financing. 3. The 10-Q with “going concern” language in it.
 - OPEC is picking up production while US shale is decreasing. Iraq is suddenly flooding the US market with crude! Kuwait’s OPEC rep says the oil glut could last 5 years.
 - EMES earnings call sounded pessimistic, but management spun some M&A false hope which propped up the stock price.
 - The price action of EMES will likely mimic that of ZINC, which bounced off lows and quickly faded.
- Note: on 11/15 we posted a [follow-up report on EMES](#): Has the bear case gotten stronger?
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Emerge Energy Services (EMES), a frac sand seller and fuel processor, is a clear bankruptcy risk. Management temporarily pumped up the stock by weaving a story about M&A possibilities. As we explain in this report, we believe there are zero M&A possibilities for EMES. The only possibilities are an imminent share dilution (in the open market, no prudent institution would make a private investment) and then a slow bleed to bankruptcy if oil prices don't recover next year. We have a \$2.50 price target on the stock because although it eventually could go to zero, we expect them to do an equity raise which will keep the company afloat for at least a year.

Emerge Energy Had A Horrendous 3rd Quarter

EMES 3rd quarter had losses much higher than anticipated. In sell side analyst Stifel's 10/23/15 report:

Given the announcement, 3Q results should be significantly worse than our and the Street estimates. In turn, we are updating 3Q15 estimates to reflect an EBITDA estimate of \$3.2 million and approximately breakeven DCF compared to our previous 3Q EBITDA estimate of \$13.3 million and DCF of \$7.7 million.

But, in fact, the company did worse than even Stifel's revised estimates. It had a \$(0.3) million EBITDA and DCF of \$(4.5) million. Its net loss was \$(0.49) per share, while consensus was \$(0.19). And financials will get worse from here, with frac sand prices 20% lower in Q415 and oil still close to \$40 a barrel.

Three Upcoming Negative Catalysts For Emerge Energy

There are no upcoming positive catalysts for EMES. However, there are three possible upcoming negative catalysts that would knock down the stock.

1. The Amendment Of Its Credit Facility

In Q315, EMES violated its leverage covenant with its lenders. In the [Q315 earnings call](#), EMES management said that they will amend their credit facility by November 13th. The terms of the amendment will be worse than before, as the banks will increase the interest rate on the loans, which will hurt the company's cash flow. The banks can also force EMES to accelerate its principal payments. On 11/6/15, EMES frac sand competitor, Hi-Crush Partners (HCLP) [amended its credit facility](#) and the stock fell 6.5% and is down much more today. HCLP's amendment increased its interest rate to LIBOR plus 4.5%, about doubling it. EMES will probably get worse terms than HCLP because it had a big loss in Q3 whereas HCLP had positive earnings.

2. An ATM Equity Financing

In the EMES Q315 earnings call, management didn't talk up the company and boost the stock for nothing. Due to its distressed situation, it's likely getting ready to sell stock. The banks will likely require EMES to raise money to pay off some of the debt. They won't say it outright, but it will be implied. EMES likely can't sell assets for a reasonable price in this market, and prudent institutions won't be willing to make a large equity investment in the company. So it will have to start an ATM equity program and sell shares in the open market. The market will punish the stock on this news because it's market cap is only about \$140m. When Horsehead Holdings (ZINC) [announced](#) their ATM equity program, the stock fell 30% the next day.

3. The 10-Q Filed With "Going Concern" Language

EMES has delayed filing its Q3 10-Q because they are having disagreements with the auditors on the

language. [Management said](#) regarding the delay:

The terms of the amendment to the Credit Agreement or, in its absence, an acceleration of the outstanding amounts under Credit Agreement would materially affect the financial statements presented in the Quarterly Report and the disclosures set forth in the Quarterly Report.

If the new credit agreement has some harsh stipulations in it, EMES may have to put “going concern” language in the 10-Q. That would authoritatively mark the company as a bankruptcy risk and spook many investors into selling.

From A Recent OPEC Meeting: “The Oil Glut Could Last Five Years”

From Bloomberg, [Kuwait’s OPEC representative said](#) on 11/7:

Oil markets will continue to be oversupplied for as long as five years as producers in the Middle East ramp up output

Iraq pumped a record 4.4 million barrels a day in June

Iran has the capacity to boost exports by 500,000 barrels a day within one week of sanctions being lifted

EMES is counting on the frac sand industry to rebound by early 2017. There’s no guarantee or even likelihood that that’s going to happen. According to the Kuwait OPEC rep, it could be another five years before a rebound. EMES won’t be able to last that long with its growing debt load.

[This just in](#) today via Bloomberg: Iraq is flooding the US with crude oil.

Iraq, the fastest-growing producer within the 12-nation group, loaded as many as 10 tankers in the past several weeks to deliver crude to U.S. ports in November, ship-tracking and charters compiled by Bloomberg show.



Last week [it was reported](#) that Saudi Arabia is now selling oil to Sweden and Poland, to compete with Russia. The Middle East isn’t slowing down its oil production, but US shale oil is. From Business Insider, [it was reported](#) on 11/6 by the oilfield services company Baker Hughes that the US oil rig count dropped again for the 10th straight week. These news are bad for over-leveraged US oil services firms like EMES.



EMES Price Action And Events Look Like A Replay Of ZINC

Our [last bearish report](#) was on Horsehead Holdings (ZINC), a commodity play like EMES. If you want to know what will likely happen to EMES stock, look at ZINC’s price action over the last month. The events that have moved both stocks are very similar.

Like EMES, ZINC was in a distressed state and its share price continuously declined. On October 2nd, ZINC was downgraded by Oppenheimer and it fell to lows of \$2.23. That day all the weak hands were shaken out, and the

stock short squeezed and rallied the next week. Once momentum shifts in these highly leveraged commodity stocks, they often move far. After it reached a peak of \$6 per share a week later, ZINC started fading and then got crushed with a one day 30% decline [when it issued](#) an ATM equity financing. It has fallen 50% since the peak of its rally to around \$3 per share today.

Similar technical stock moving events have played out with EMES. It reached a low of \$3.78 on October 27th when [Baird lowered its price target](#) from \$3 to \$0 per share, and [Stifel lowered its price](#) target from \$8 to \$1 per share. Since then, EMES has rallied to a high of \$8.28, and now is trading below \$6. Just like what ZINC did, EMES will likely announce an ATM equity financing, and the stock will likely fall to \$2-\$3 per share.

One can make the argument that EMES is in a worse position than ZINC. ZINC sells zinc, which is more of a rare and precious mineral compared to the frac sand that EMES sells. There's an unlimited amount of sand, and it's a fairly easy chemical process to turn it into frac sand.

Emerge Energy's Earnings Call Was Negative, With M&A False Hope

Baird's \$0 PT and Stifel's \$3 price target of EMES should be listened to, because those sell-side analysts have been following the company for a long time, and had much higher price targets earlier this year. A lot was said in the [EMES Q3 2015 earnings call](#) that shows things are even worse than expected for the company. The market took the call positively because management was talking about potential M&A possibilities. But overall, nothing positive was really said.

The following are comments from the earnings call, and our analysis of those comments. The earnings call comments are in italics.

Said EMES CEO Rick Shearer:

We have also seen this downcycle as an M&A opportunity, should the right strategic play come about at an exceptional value. We are currently looking at various M&A options, but completing the transaction will largely depend on our ability to secure appropriate financing.

This comment by the CEO was a big reason for the stock's recent rally, but it's smoke and mirrors. EMES is not in a position to be acquired or do any acquiring or merging. Yesterday, there was a [Seeking Alpha article](#) suggesting that US Silica (SLCA), the leader in the frac sand industry, cut its dividend because it might acquire EMES or HCLP. This is not the case. SLCA doesn't have the net cash to acquire these debt-laden distressed companies. If SLCA does any acquiring, it will be of a smaller company or assets. Mainly, SLCA cut its dividend because the industry is so bad right now, it doesn't want to find itself in a distressed situation.

Said Mr. Shearer:

An ASP evaluation shows our average FOB plant pricing currently at \$36 a ton, which is above the industry average, but approximately 7% below our Q2 level.

There are continuing indicators which suggest that we will see further pricing erosion in Q4. More and more, we are heading and hearing FOB mine gate sand pricing moving further down into the \$24 to \$22 a ton range.

EMES could lose 30% in frac sand revenues in Q4 over Q3. Due to its take-or-pay, fixed-volume, and efforts-

based contracts with about 70% of its customers, EMES is able to sell its sand for about a 15% premium above market prices. But as time goes on, those contracts are expiring, and EMES premium pricing is eroding. About 73% of those contracts are efforts-based, which isn't as good for EMES as take-or-pay and fixed volume in a declining market.

Mr. Shearer said:

While much progress has been made to reduce costs on many fronts, like others in our industry we continue to struggle with our railcar leases and storage fees. We currently have 2,328 railcars in storage out of the total fleet of 4,804 cars.

Managing this railcar storage challenge is a top priority for our team. We expect to have some portion of further inbound railcars halted in 2016, but we have another 400 cars still to enter our system within the next few months.

Railcar storage costs are a big problem with EMES. The further decline of frac sand prices confirms that fracking companies are demanding less and less sand, which means EMES will have to idle even more railcars. The storage cost for EMES is currently \$4.3M per quarter, and will grow as more railcars come into the fleet. In addition to those 400 cars on the way this year, EMES had already ordered more cars in 2016 that will be coming in which the company is trying to halt.

Mr. Shearer said:

Our third target to improve our market position was to broaden our customer base. We simply did not want to be heavily dependent on two or three customers as in the past. This too has been accomplished. Thanks to the good work of our sales and marketing team.

It's good that EMES isn't reliant on just a couple of customers. But on the downside, now that it has a wider customer base, there's more of a chance it will lose some customers.

Conclusion

While EMES management talked a big game in the Q315 earnings call, there was nothing solid that suggested investors should be optimistic. When EMES amends its credit agreement, its interest rate will be pushed up and will likely be a disappointment to the market, pushing the stock price down. The renewed optimism from investors, pushing the stock up in the past couple of weeks, will likely lead to a massive equity raise, likely an ATM. The news of the ATM will spook investors to sell. Then the subsequent tapping of the ATM by the company will push shares down further.

Disclosure: White Diamond Research and clients are short EMES.



Independent institutional-grade research focused on identifying asymmetric risks in small and micro-cap equities.

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