OIL & GAS RESEARCH

JENNINGS CAPITAL INC.

Sector: Oil & Gas
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HSE INTEGRATED LTD. (TSX-V – HSL $2.60)

Update Report.
Share Price Target Increased.

Recommendation:	**BUY**
12-Month Target:	**$ 3.50**
Previous Target	**$ 2.25**

Last	$2.60
12 Month High	$3.05
12 Month Low	$1.25
Fiscal Year End	31-Dec
Shares - O/S Basic	29,622,421
Shares - O/S FD	33,767,418
Market Capitalization - Basic	$77,018,295
Total Net Debt. (09-30-05) ***- Estimated***	($12,120,611)
Enterprise Value	$64,897,684
Net Book Value - June 30, 2005	***$1.25***

Jennings Capital has been engaged by HSE Integrated Ltd. for a fee in the last 12 months.

Source: www.BigCharts.com

	2003	2004A	2005E	2006F
Revenues ($ Million)	$12,220	$21,176	$52,000	$70,000
EBITDA	$1,246	$1,794	$7,800	$10,500
Net Income	($19)	$0	$3,120	$4,200
$ per share	$0.00	$0.04	$0.12	$0.14
P/E	-	-	22.1X	18.6X

- HSE Integrated Ltd. (formerly Patch Safety Services Ltd.) is a Calgary-based, specialist services provider for the oil and gas upstream industry in the areas of Health, Safety and Environment.
- Since our **BUY** recommendation in January 2005, HSE shares have seen a 67% price appreciation and have exceed our $2.25 target. This move has been fuelled by a strong equity market in the oil and gas sector and a record financial performance from the Company.
- Since our previous report described the Company and its business environment in detail, this research note will be more of an update on the financial results reported to-date, with a revised outlook for the remainder of the year and our best estimate of what we may expect in 2006.
- On a year-over-year basis, for the six-month period ended June 30, HSE has enjoyed a significant increase in revenues, EBITDA, operating cashflow and earnings. This reflects the vastly increased capacity of the Company created by the acquisition of seven competitors in 2004, and strong business conditions driven by high oil and natural gas prices.
- The Company continues to seek acquisitions and successfully completed three in 2005, acquiring CRS Technologies (1990) Inc., Confined Space Response Services Inc. and certain assets and the oilfield safety services business of Standard Safety and Consulting Services (1978) Ltd. ("Standard") of Edmonton.

- The Company's operating results for the six month period include three months of high activity, the first quarter ended March 31, and the traditional three month seasonal period of low activity, the second quarter ended June 30. The high levels of activity in the first quarter fuelled by ongoing high commodity prices ended abruptly in April, when the seasonal thaw caused by spring break-up restricted field activity, resulting in a sharp reduction in demand for services provided by HSE. Record rainfall throughout much of the areas in which HSE operates hampered the attempts by its customers to proceed with their 2005 oil and gas drilling and development programs during the second quarter.
- Although industry activity levels as measured by oil and gas well drilling and completion activity were similar in the first six months of 2004 and 2005, comparative financials reflect the impact of the Company's seven acquisitions in 2004. For the six month period, revenues were up 362%, net income was up 961%, operating cash flow increased 501% and earnings per share rose by 291% over the same period in 2004.
- However, several initiatives in the second quarter which were intended to improve the long-term financial performance of HSE, resulted in increased operating costs. In Q2, HSE undertook the complete integration of the SDS Group Inc. acquisition that closed December 15, 2004. This was delayed until the spring because of high activity levels at the time of closing.
- Downsizing in Sales and Marketing resulted in severance costs. All acquired shops, vehicles, field equipment, field tickets and stationary were rebranded under the HSE banner. The rebranding of all other assets acquired in other transactions was also completed.
- Two new field locations were opened in the second quarter, which created one-time setup costs. HSE took possession of its new shop in Pincher Creek on May 1 and in Fort McMurray on June 1, 2005.
- HSE invested heavily in management and sales training programs, which are non-recurring costs intended to help HSE operate more effectively in the future.
- On June 23, 2005, HSE completed a $12 million equity financing to provide capital for continued expansion. In addition, the Company negotiated a new credit facility with the CIBC to replace its existing facility. The new demand facility provides for base operating facilities of up to $10.1 million, combined with additional installment facilities of up to $9.9 million. Funds from these facilities will be used to finance HSE's expanding activities and complete its 2005 capital expenditure program.
- Revenue is earned by providing a variety of worker safety and equipment protection services, including onsite safety supervision, gas detection and breathing equipment rentals and services, fire fighting and fire protection, worker shower deluge services, on-site medical services and safety training.
- In its current business model, the Company is driven largely by the level of drilling, completion and well servicing activities within the upstream oil and gas sector and, to a lesser degree, by providing safety services to plants and facilities while they perform maintenance turnaround and shutdown projects.
- Due to high levels of industry activity in the first quarter and expanded equipment and manpower capacity, HSE has been successful in obtaining higher pricing for its field services. These higher prices have been generally accepted by HSE's customers, because the primary cost increases to the Company have been in the areas of labour and fuel, factors that affect all industries operating in Western Canada. Customers anticipate that suppliers' costs will rise in these areas.
- Additionally, the Company has observed that its extensive capacity, as well as its ability to provide a wider breadth of services than its competitors, are seen as competitive advantages by its larger customers. This has enabled the Company to be a price leader in some areas.

- On a year-over-year basis, HSE still enjoyed an improved gross profit margin, which was attributable to several factors. The Company's increased capacity enables it to allocate its resources more effectively and minimize the number of times it has to relocate men and equipment at its own cost, when responding to local demand issues, especially during peak activity periods. Finally, in the first half of 2005, the Company provided a number of services considered specialty services, for which it received a premium margin. These services were not within the HSE product mix in 2004.
- Operating expense consists of costs directly attributable to the provision of safety and related services to customers. These include wages and benefits for field employees and contractors, equipment rentals and leases, transportation, fuel, consumables, equipment repairs and maintenance and field office administration, including field sales.
- Operating expense including sales and administration for the six months ended June 30, 2005, was $23,017,505 or 86.2% of revenues as compared to $6,814,929 or 92.4% of revenues for the same period in 2004. These levels translate to gross margin percentages of 13.8% and 7.6%, respectively, which as we noted for the first half of 2005, were adversely affected by a number of extraordinary expenses.
- Based on current market conditions and using existing capacity, we expect HSE revenues to exceed $50 million in 2005 and without additional acquisition, top $60 million in 2005. Since management has stated an aggressive acquisition strategy, 2006 revenues could exceed $70 million. Gross margins of 15% would generate an EBITDA of $7.5 million in 2005, which exceeds our previous estimate of $6.3 million. Assuming this margin is maintained into 2006, which in the current high commodity environment looks likely, plus the company's ability to layer in several additional acquisitions, EBITDA of $10.5 million for 2006 is a reasonable target. With a enterprise value of $65 million, HSE is trading at 6.2X 2006 EDITDA as compared to the average EV/EBITDA for oil services based comparables in the 9.0X range.
- With the Company's basic business environment likely to improve and existing management's demonstrated ability to react in an aggressive acquisition manner, we are comfortable maintaining our **BUY** recommendation in spite of the very nice share price advance. We consider a share price target in the $3.50+ range as very achievable in the coming twelve months.

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