Special Feature: My Oil Stock to Watch for 2019

A Deep Dive into the Bargains and Safety in the Canadian Energy Sector

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A Katusa Research Special Report

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Is Oil The Ultimate Value Trap?

The Canadian Oil Patch is the most beaten-up and hated-on oil sector in the world.

Over the past few months, the Canadian oil sector has been more volatile than I can remember.

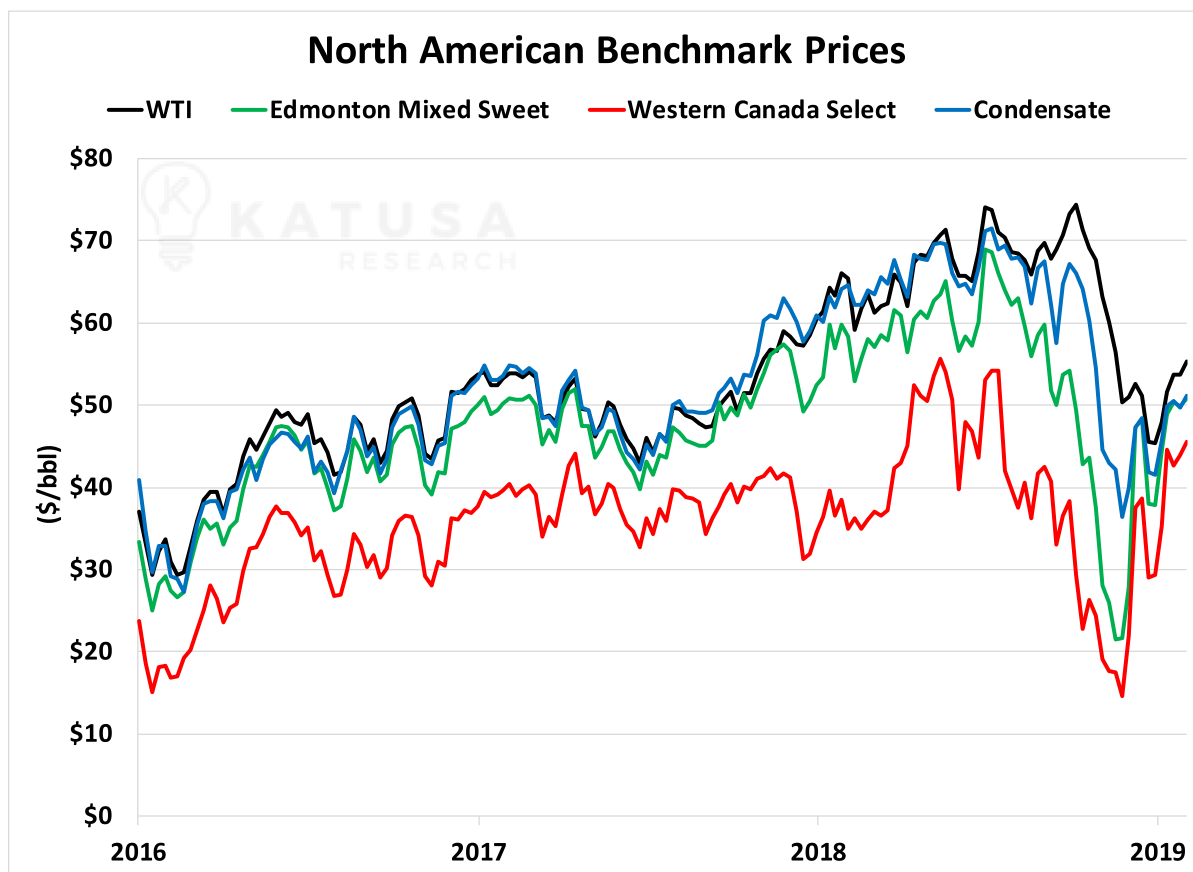
Between Trump tweets, pipeline debacles in Canada and OPEC production decisions… it's been a treacherous time for oil and gas producers in Canada.

It took oil prices nearly two full years to recover from their January 2016 lows.

And in the span of less than two months, that recovery has been decimated. Especially with the United States benchmark crude oil price dropping below $50 per barrel.

In Canada, the producers gave up on profit as they were practically giving away their production, as prices fell to $20 per barrel.

Below is a chart which shows the price per barrel (USD) of North American crude benchmark oil prices.



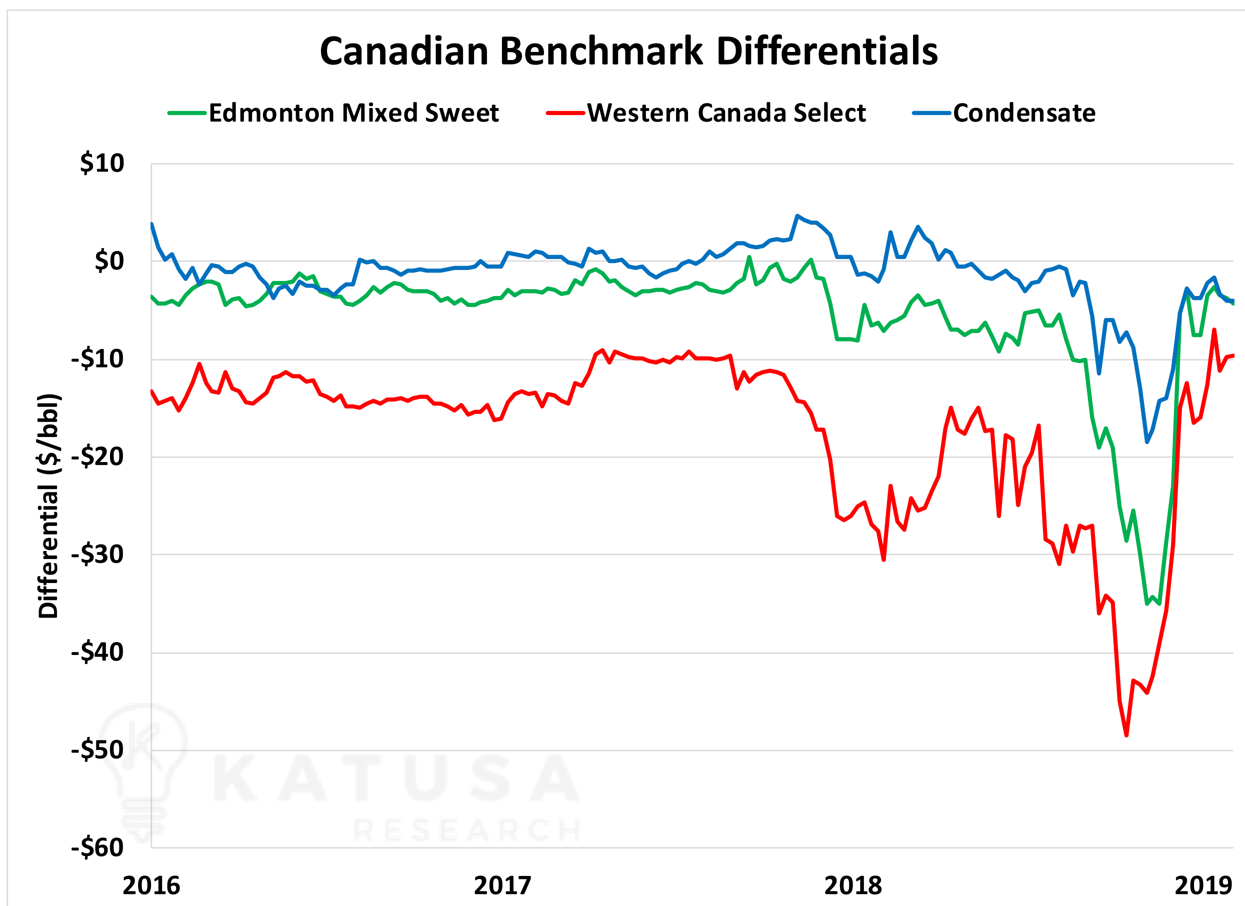
The Canadian oil patch worked through what is known as a "*negative differential*" for years.

A negative differential is a fancy way of saying that American benchmark oil (WTI) sells for a premium to the Canadian benchmark (known as Edmonton Mixed Sweet).

On a specific gravity and sulphur basis, the two crudes are reasonably similar.

Yet Canada's oil sells for a huge discount.

The green line in the chart below shows the differential between Canadian benchmark crude oil and WTI for the last three years. It's substantial.



Why Does Canadian Oil Trade at a Huge Discount?

Canadian oil sells for a big discount for a few simple reasons.

First, Canada produces more oil than it can efficiently refine through its domestic crude oil refineries. In Canada there is less than 2 million barrels per day of

refining capacity. For comparison, the United States has over 18 million barrels per day of refining capacity.

Secondly, Canada does not have the pipeline capacity to export crude oil to the United States. Never mind export capacity to the west coast— it's not happening for many years.

The supply glut could be solved easily if there was enough pipeline capacity to ship the crude to the United States refineries and to the coast to be shipped to Asia. But there is not.

The end result is a large supply glut and a substantial discount in price for Canadian crude oil.

This past fall, Canadian light crude differentials were approaching $40 per barrel.

This means that if American crude oil was selling for $60 per barrel, the light oil in Canada (Edmonton Sweet) was selling for $20 per barrel.

Those with a sharp eye will notice the differentials have narrowed considerably over the last few months. They have gone back to levels not seen in several years.

The reason for this was government intervention.

Recently, The Alberta provincial government has stepped in and ordered a production cut of 325,000 barrels per day. That's very un-free market of the Canadian Province.

Or one can say very OPECish of Canada.

The government also said they'd buy rail cars to help move crude south to American refineries—how dumb. It's a band-aid solution instead of a long term, safer solution. Did you expect anything better from the Canadian government?

Normally, government intervention in oil production is only used as a tool by nations that operate State Owned Enterprises (SOE) and OPEC.

It's one thing to tell government workers to cut production; it's another to tell a public company with thousands of shareholders that they have to cut production.

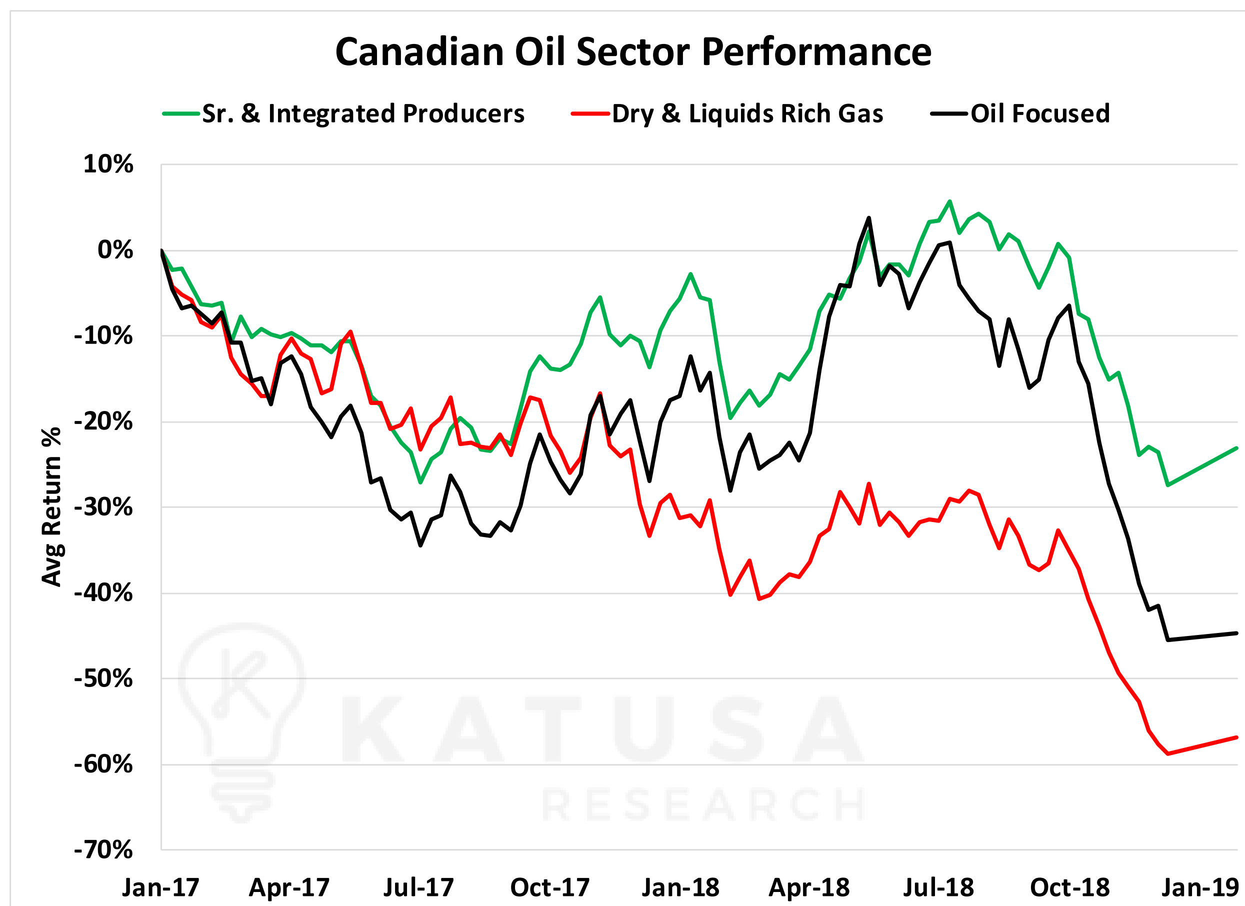
That said, something needed to happen. And it was easier to lash out on the shareholders than to hurt the uneducated, unscientific based protestor's feelings.

Hey, the protestors are working for someone's agenda—it just isn't for the best interest of Canadians.

The federal government has been useless at pushing through the Trans Mountain Expansion Pipeline. With that pipeline tied up for the foreseeable future waiting for a National Energy Board decision, there's little visibility into things improving.

And that has a massive effect on the confidence in the stock price of Canadian oil companies. Below is a chart which shows the two-year performance of Canadian oil and gas producers.

There really has been nowhere to hide...



Now I could provide a dozen more metrics our team has run that show a pattern of increasingly undervalued companies.

You might think it must mean that there's a whole bunch of great oil and gas companies to load up on, right?

Wrong.

For long-term investors, the Canadian oil sector as a whole is stuck in what I call a "value trap."

Until oil prices rise significantly or the Canadian Dollar collapses further to the U.S. Dollar. Pipelines won't be coming to the rescue anytime soon.

A value trap refers to a situation in which a company's share price has been hammered so that it appears to be cheap – just like in the Canadian oil patch.

But what many unsophisticated investors miss is *why* the stock is cheap.

Until that reason is eliminated or solved, anyone who invests capital into the company is stuck in a languishing stock. Hence the term “trap”.

If the Canadian government had its act together…

And had gotten a pipeline decision finalized, construction going…

And all looked promising…

I’d be more inclined to say we have broken free from the “trap.”

However, that’s not the case in the Canadian oil patch. We’ve yet to see if Canadian producers will cut production. Nor have we seen the rail cars purchased, and the pipeline situation is still a mess.

Where are the Crazy “Bargains” in the Canadian Oil Sector?

If you could buy a $15,000 Rolex for $5,000 would you?

How much is it ***actually worth*** and to ***who***?

The answer is *exactly how much someone else is willing to pay for it.* And right now, investors are not willing to pay much for Canadian oil stocks.

We have been watching the situation very, very close. We are familiar with many of the operations and teams in the land of maple syrup.

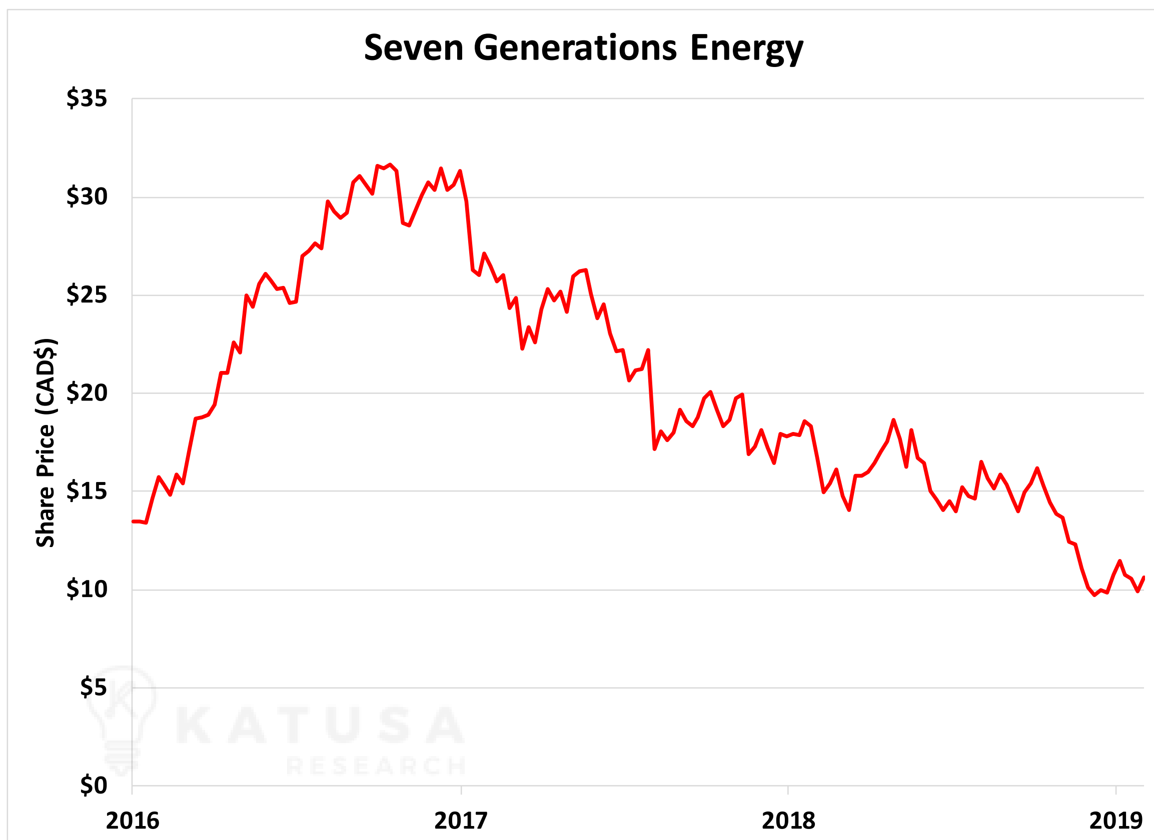
One situation we’re monitoring closely is multibillion dollar market cap companies falling out of favor. They’re falling safes that have yet to hit the floor

Back in in the **July 2017 KRO**, I made a bold prediction about the U.S. and Canadian oil patch. Albeit a bit early…

> ***Seven Generations Energy (VII.TO, US ticker SVRGF)*** *is the premier condensate producer in Canada. Condensate is a heavy hydrocarbon chain which is part of the natural gas molecule. These condensates are worth as much or sometimes more than the equivalent amount of oil.*
>
> *Seven Generations Energy has an enormous acreage position and produced over 150,000 barrels of oil equivalent last quarter. The company completed an initial public offering in the fall of 2014 and has since traded as low as CAD$12 per share and as high as CAD$33 per share.*
>
> *Right now, shares of Seven Generations are trading at 1-year lows and can be had for CAD$22 per share.* ***I believe the share price hasn’t bottomed out yet.***

> ***Condensates are priced based off the oil price. In a weak oil market, the market for condensates will be weak…***
>
> *I will wait on the sidelines as I think the shares will break under CAD$17 per share and then drift lower with time.*

Not too long after, Seven Generations stock drifted lower with no end in sight.



But even in the “***Value Trap***” there is the “***Value Trap Bounce***”.

A handful of stocks in the Canadian oil sector are looking very ripe for the picking right now.

These are stocks that have potential for quick 50-100% gains in under 2 months. And long term, if oil turns around, these former market darlings could gain 2x or even 5x long term.

But which companies can withstand the “echo” markets?

The *echo* is the long, drawn out, sideways trading period where only the strong companies survive and thrive.

This is where analytics comes in.

Our research team has looked at all the key metric for companies in the Canadian oil patch.

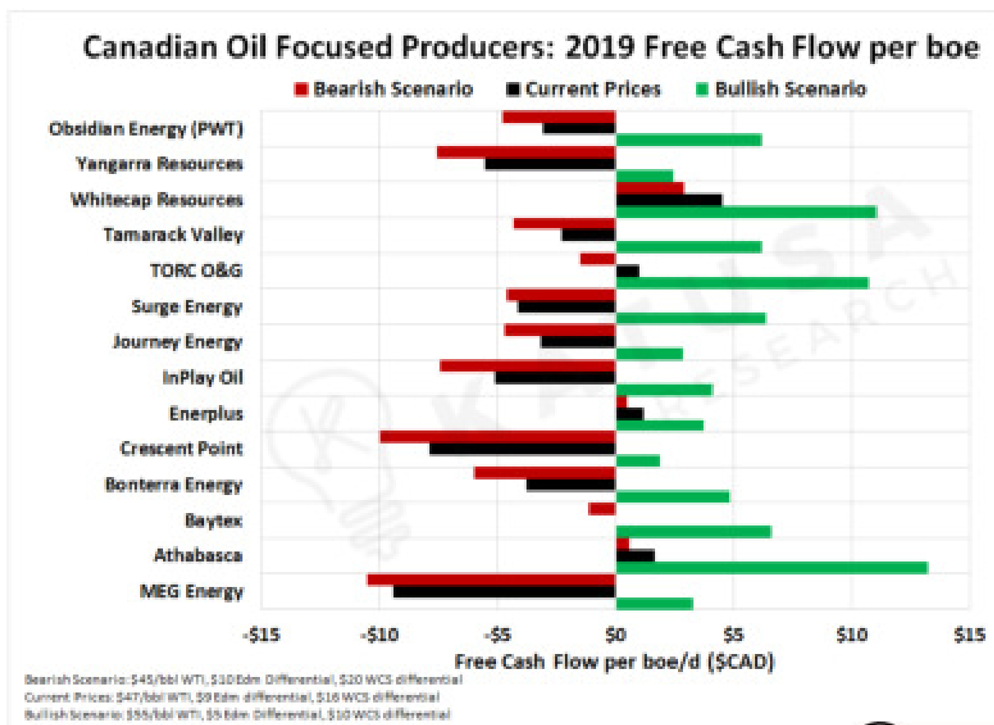
A Deep Dive into the Bargains and Safety in the Canadian Energy Sector

Let's take a deeper dive into the Canadian energy sector, specifically the oil focused producers. The peer group has been decimated this year, down roughly 45%. Tax loss victims are abundant. But it's important to be able to distinguish deep value from value traps.

My main signal for Canadian oil producers is free cash flow generation. This calculation uses total cash flow generated from annual production minus operational expenses, interest payments, administrative costs and capital expenditures.

Below is a chart which shows the Katusa Research free cash flow per barrel estimates for several Canadian oil producers under three different scenarios. All scenarios use the current USD/CAD exchange rate ($1.34).

- A bearish case, using $45 per barrel WTI
- Current prices, using $47 per barrel
- A bullish case, using $55 per barrel

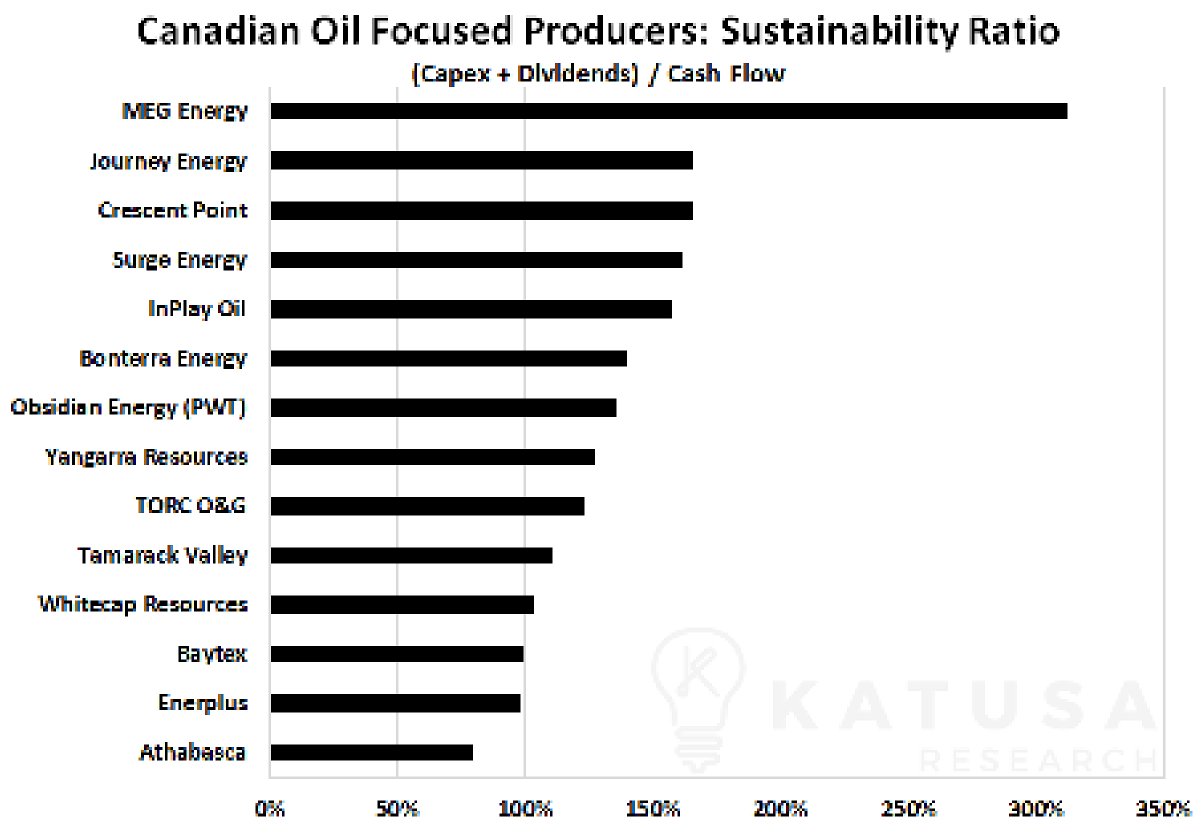


You can see that nearly all of the companies listed above have negative free cash flow unless oil prices rise above $55 per barrel next year.

Are the Dividends Safe?

The big draw for Canadian investors and funds is the dividends that Canadian oil companies pay. But when oil prices fall, companies are forced to cut dividend payments. There isn't enough cash flow to cover all the expenses.

Below is a chart of the ratio I use called the *Sustainability Ratio*. It is a ratio of annual capital expenditures plus annual dividend payments divided by annual cash flow (Capex + Dividends) / Cash Flow.



- A ratio of less than 100% indicates a company can cover capital expenditures and dividend payments with its cash flow.
- A ratio of more than 100% means the company's cash flow will not cover all of its capital expenditures and dividend payments, meaning it is overspending.

As shown in the graph above, nearly all Canadian oil producers are overspending at current price levels. And given the current macro oil picture, I don't think oil prices are going to skyrocket anytime soon.

When Will the Trap End?

I know the last few pages have been rather doom and gloom for the Canadian oil patch. Especially the point about the sector being a value trap right now.

Even if things get better, there is still the big issue of takeaway capacity (lack of pipelines). Without additional pipelines to export crude oil, if oil prices rose by 50%, Canadian producers could not fully capitalize on the opportunity. That makes it a lousy place to invest. Why take the risk, for a chance at only half the reward?

I do think, however, that the tide is going to turn – eventually.

The federal government spent CAD$4.5 billion of taxpayer money on a stalled pipeline project. That's not winning the federal government any votes from either side, and Canadian national election takes place in late 2019. Something will have to change.

In the meantime, most of these companies are a value trap. But they are also so oversold that you can expect a near-term bounce.

We have come up with a unique idea this month to take advantage of the current state of the Canadian oil patch.

Finding Deep Value in the Canadian Oil Patch

The oil-focused peers have fallen an average of nearly 45% year to date. Over the last few months, some companies have seen their share prices fall by 50%.

Couple this with the recent hammering of oil prices down to $45 on December 24th, and I think a lot of investors and funds have thrown in the towel.

Even with all the doom and gloom in the sector, I do believe there is deep value for a short-term speculation.

This is my approach to finding a tax-loss speculation

1. High equity beta

Beta is a measure of the volatility of a stock compared to the volatility of a major index.

If a stock's beta is higher than one… it's expected to move more than the average index (on a % basis).

If a beta is less than one… it will be expected to be less responsive and move less than the index (on a % basis).

We want high beta, because we are going for a short-term trade where fundamentals mean less and technicals mean more. If there is a rising tide that's lifting the boats, we want our boat to rise fastest.

2. Free cash flow positive at current oil prices

Even though I just said fundamentals are less important in a short-term trade, you don't want to run out and buy worthless moose pasture. No one buys moose pasture, especially in a bad market. Investors of all sizes flock to best-in-breed names first. If a company can produce free cash flow in this environment, they are certainly best-in-breed.

3. Trade below proven reserve NPV

Each year, petroleum engineers value a company's oil and gas reserves. The reserves are separated into two categories:

a. Proven reserves, which are expected to be economically extracted with 90% certainty.

b. Probable reserves, which are usually around 50% certainty of economic extraction.

A company trading below the NPV of proven reserves serves as an excellent backbone to valuation.

4. Worse 1 year performance than the rest of the peer group

Bonus points if the company is down significantly over the past three months. We want to buy deep value. And if a good company has already taken a big stock price decrease, we want to buy oversold, high-quality names.

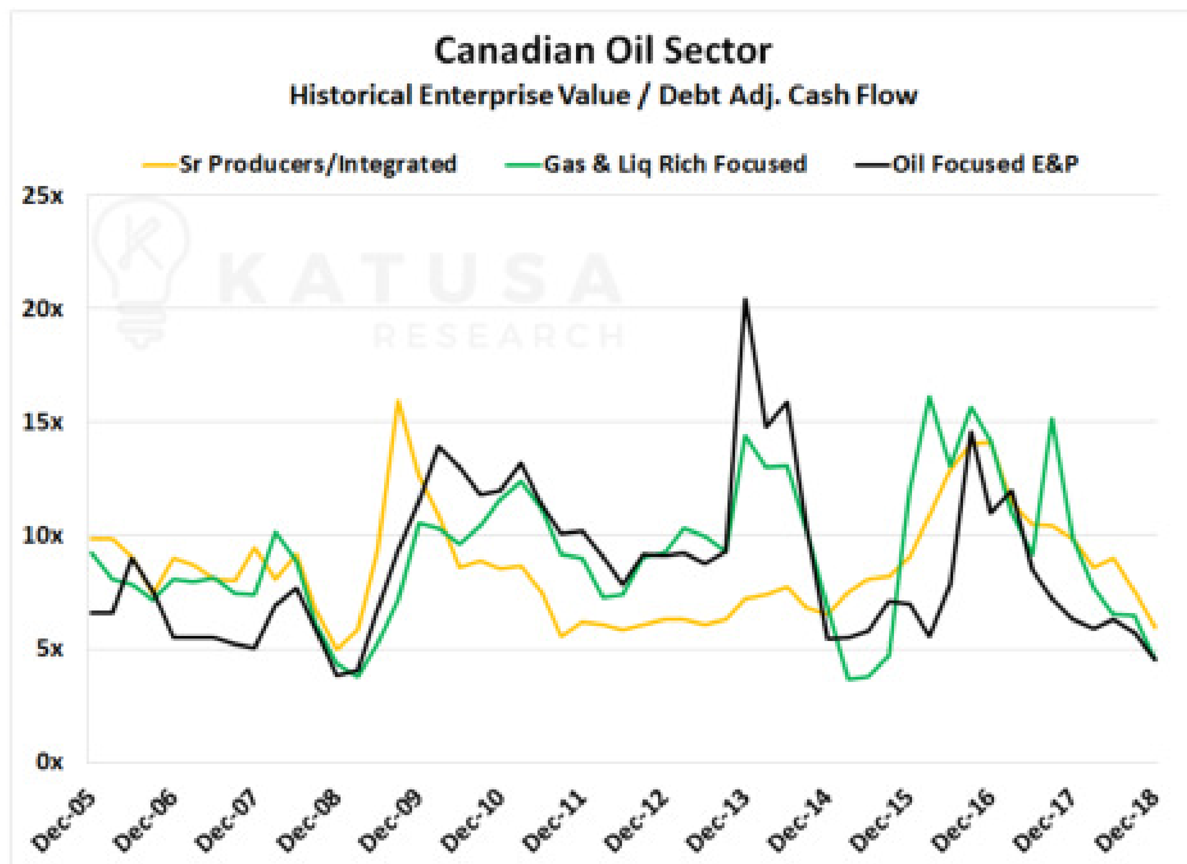
Now a word of caution before I get to the speculation.

This is a short-term trading opportunity (0-6 months expected hold period). If you are not comfortable buying and selling a stock with a few months-time frame, then this opportunity is not for you. This is a high-risk setup.

Below is a chart which shows one of my favorite metrics for analyzing oil and gas companies. It's the ratio of *enterprise value* (market capitalization – cash + debt) divided by *cash flow* (which has been adjusted for tax rebates on interest and exploration payments). It's known as *Debt-Adjusted Cash Flow,* or *DACF*.

A high ratio indicates a potential overvaluation, whereas a low ratio could indicate undervaluation.

You'll see in the chart below that companies are approaching all-time DACF lows.



With that, let's get to one of the best oil plays right now…

Whitecap Resources (WCP.TO)

Whitecap Resources is a large oil producer that has been in business for over a decade.

It is run by Grant Fagerheim, who is one of the most reputable guys in the Canadian oil sector.

Company Information	
Company Name	Whitecap Resources
Primary Listing	TSX: WCP
Secondary Listing	OTC: SPGYF
Market Capitalization	CAD$1.6B
Balance Sheet & Structure	(CAD$)
Cash	$0
Total Debt	$1.2B
Dividend	8.10%
Shares Outstanding	416M (422M fully diluted)
Options	6.3M (Avg. exercise price $8.89)
Production Profile	**2019 Estimates**
Oil (bbls/d)	55,661
Gas (Mcf/d)	66,876
NGL (bbls/d)	4,193
Total (boe/d)	71,000
Areas of Operations:	Alberta, Saskatchewan
Production Pipeline:	Cardium & Viking formations
Company Catalysts	Global oil prices & Canadian oil differentials

The strategy here is to capitalize on the tax-loss selling that has occurred at the end of 2018 crushing oil stocks. Shares in Whitecap have fallen from CAD$8 to CAD$4 in under three months.

The company's dividend yield is near 8%, which I believe it can sustain in 2019.

Whitecap locked in oil hedges for 40% of its 2019 production at an average price of CAD$74 (USD$54.80).

By my calculations at current oil prices, differentials and exchange rates, the company will generate CAD$569 million cash flow in 2019, while spending CAD$450 million in capex and paying out CAD$134 million in dividends. This works out to a sustainability ratio of just 103%.

I'm okay with this number.

If the company's sustainability ratio was 150%, I would not be making this recommendation. Dividend stability is key to driving new investors into the company in the New Year.

The company has no major debt payments upcoming in 2019 or 2020 that could be a drag on the stock.

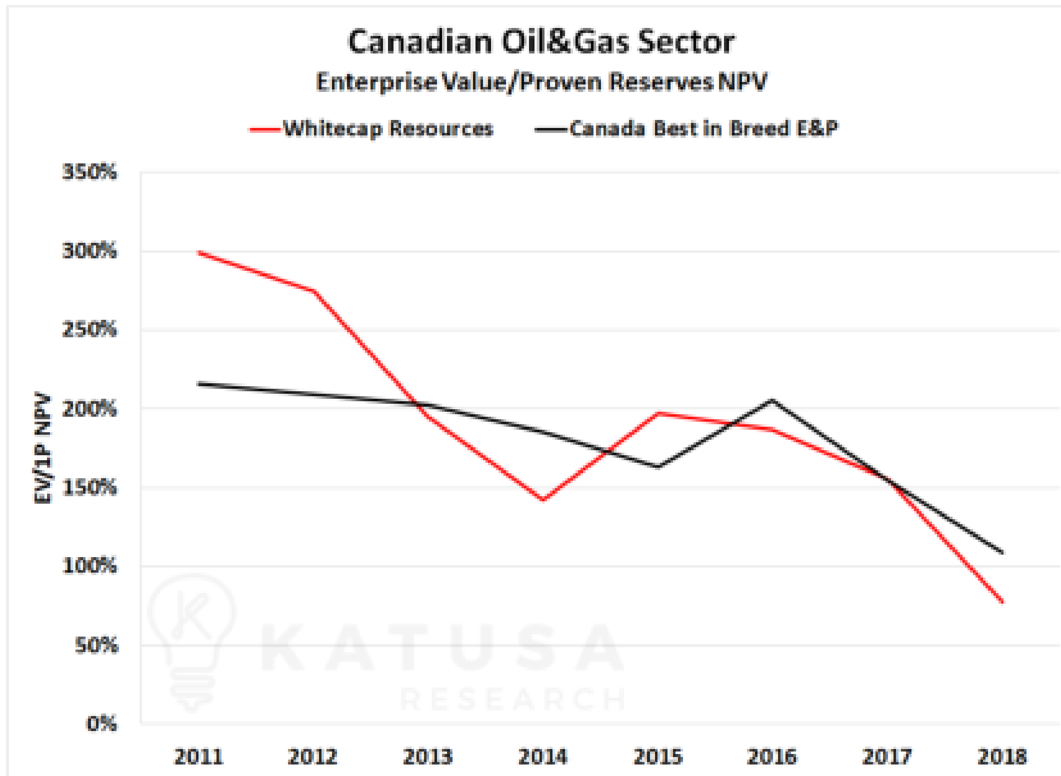
Below is a chart of Whitecap's share price taken from my Bloomberg Terminal. You'll see it's been decimated in the last three months of this year.

I believe the stock is highly oversold at these levels.

Right now, Whitecap is trading at just 68% of the NPV of its proven reserves.

In fact, it's even trading at a discount to its producing proven reserves (which is the NPV of cash flow generated from wells that are already producing).

The chart below shows the historical trading level of Whitecap to the NPV of its proven reserves. You'll see this is the first time in more than eight years it has traded below the value of its proven reserves' NPV.



Whitecap Resources – Buying Strategy:

I'm only going to be buying a single tranche.

I do not want this position to become a large portion of my portfolio. This is meant to take advantage of a short-term situation and generate a quick return.

Whitecap Resources – Selling Strategy:

Assuming my hypothesis is correct and we get a bounce, I'm selling my position as soon as I'm up 20-25%. Then, make sure you set a stop-loss order at your entry price.

This means that if you buy shares at CAD$4 and sell 50% of your position at CAD$4.80-$5 per share.

Look to continue to take profits until you have only free shares remaining. Ideally, we'll all end up with a *Katusa Free Ride* on a few shares that will pay us an 8% dividend.

If the share price remains range bound around the CAD$4 level, I am comfortable holding this first tranche for a few months and getting paid a nice dividend.

Only buy ¼ of your desired position, which means buy the first tranche only.

If the oil sector crashes and Whitecap continues to break down, I will likely look to close the position for no more than a 20% loss.

Regards,

Marin

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