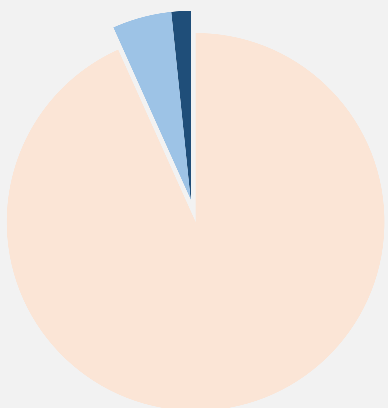
Daily Thought

Activism in Oil and Gas – August 18th, 2023

There's not a whole lot of interest in this sector, and the number of energy specialists that dabble in Canada are even fewer than before. So far this cycle, our two majors activist campagins have been Elliott for Suncor, and Kimmeridge for Ovintiv. Both ended without fireworks, with the respective instigators appointing board members. Really, on aggregate, there's not really even a threat of activism among Canadian upstream companies. Among all unique Canadian E&P instiutional holders, ~6% pose any real activism threat, and <2% are classified as high risk of activism. Compared to the broader TSX index (excluding resource and bank stocks) where 10% of unique institutional holders ranking as medium or higher, on FactSet's activism threat index.

(Fig. 1) Canadian Upstream Inst. Holder Activism Threat



Source: FactSet, HTM Analysis

Contrary to many – we see this as a great thing. Of the 135 TSX listed companies that are energy, midstream, and services related that we consider "serious", ~1% of the group's total cap ($610bn) would we classify as having "poor governance". While that would still imply $8bn of market capitalization being staffed with poor leaders, this is significantly less than a decade ago.

Increased emphasis on ESG, including the "governance" part, has improved board dynamics, improved shareholder representation (through the emphasis on truly independent directors). Industry consolidation has generally helped as well, with smaller, more casual issuers are typically prone to governance problems. Lower commodity prices have worked to extinguish operators that don't excel across all facets of their business, though in 2022, we've seen some less than savoury operations emerge, or even reemerge (including PEI, PPR, RZE, VIK, and WCE). Though, with the cumulative market value being <$100m – it's not a theme among the $600bn industry.

Really, we don't see governance as a big issue among "serious" Canadian issuers. Serious being of size, and scale to really matter (think in broad terms >5,000b/d). While ATH, FEC, PIPE, SGY, and SOIL all suffer from marginal governance issues, for the most part, they are improving (Athabasca's recent Montney sale transaction, coupled with their independent drilling on their MUR JV land signals improved focus on running a good business instead of being the defacto choice for commodity leverage).

Daily Pricing & Week on Week Benchmark Chg.

CAD Priced Liquids

Condy | **$104.77** (-2.0%)
Bonny Light | **$119.02** (-2.3%)
Synthetic | **$112.14** (-3.1%)
WCS | **$84.20** (-6.8%)

USD Priced Liquids

LLS | **$83.39** (-2.2%)
MEH | **$82.09** (-2.7%)
NYMEX | **$80.39** (-2.9%)
WTI FOB | **$82.53** (-0.4%)

CAD Priced Gas

AECO | **$2.63** (-14.0%)
Alliance | **$2.31** (-17.7%)
Empress | **$2.63** (-15.3%)
Station 2 | **$2.64** (+23.9%)

USD Priced Gas

Dawn | **$2.30** (-10.3%)
Houston | **$2.43** (-9.3%)
Malin | **$3.45** (-16.6%)
PG&E | **$5.20** (-8.8%)
SoCal | **$5.74** (+16.0%)
Waha | **$2.14** (-12.0%)

HTM Energy Research

So, seeing a quasi-activism campaign launched by Bison Interests (a Houston based energy investment firm led by portfolio manager Josh Young) is confusing to us. While we certainly agree that Pipestone may have seen a better bid, or grown their share price organically as a standalone entity, the Strathcona transaction offers shareholders the opportunity to amalgamte into an entity with better governance, and better prospects (while Pipestone indeed offered deliniation upside, and why we liked it, Strathcona offers almost certain growth).

(Fig. 2) Historical Canadian Shareholder Activism Campaigns

Target	Activist	Ownership	Announced	Activist Goal
Pipestone Energy	Bison Interests	<5%	08/2023	Concerned about the proposed Strathcona transaction
WesCan Energy	Leo Berezan	20.0%	08/2023	Letter sent concerned about governance
Peyto E&D	Glass Lewis	n.m.f.	05/2023	Urged shareholders to block board nominees
Cathedral Energy	Resource Equity Partners	8.0%	04/2023	Letter sent stating concerns towards governance
TransGlobe Energy	Horizon Partners	Unknown	09/2022	Intent to block the company's merger with Vaalco
Suncor Energy	Elliott LP	3.4%	03/2022	Proposal to add new directors, and a management review
Ovintiv	Kimmeridge Energy Mmgt.	2.5%	11/2020	New capital allocation plan, and board nominations
Ovintiv	Letoko, Krosseau & Associates	Unknown	11/2019	Intended to vote to block the exit from Canada
Iron Bridge Resources	Velvet Energy	n.m.f.	05/2018	Velvet intended to acquire Iron Bridge
Crescent Point Energy	Cation Capital	0.3%	04/2018	Letter sent to nominate 4 board members
Obsidian Energy	Kernwood Ltd.	6.9%	01/2018	Intention to appoint a new board member
Obsidian Energy	FrontFour Capital	6.2%	10/2017	Letter to nominate board members
Gibson Energy	M&G Investment Mgmt.	19.4%	08/2017	M&G urged the company to improve costs and sell a refinery
TransGlobe Energy	Montrusco Bolton	7.9%	12/2015	Urged the company to repurchase stock
Rock Energy	FrontFour Capital	18.8%	10/2015	Engaged in proxy battle for board members
Legacy Oil and Gas	FrontFour Capital	6.8%	04/2015	Nomination of 3 directors to block a sale to Crescent Point
Agrium	Jana Partners	7.6%	07/2012	Proxy fight for five board seats to spin the retail business

Source: FactSet SharkWatch, HTM Analysis

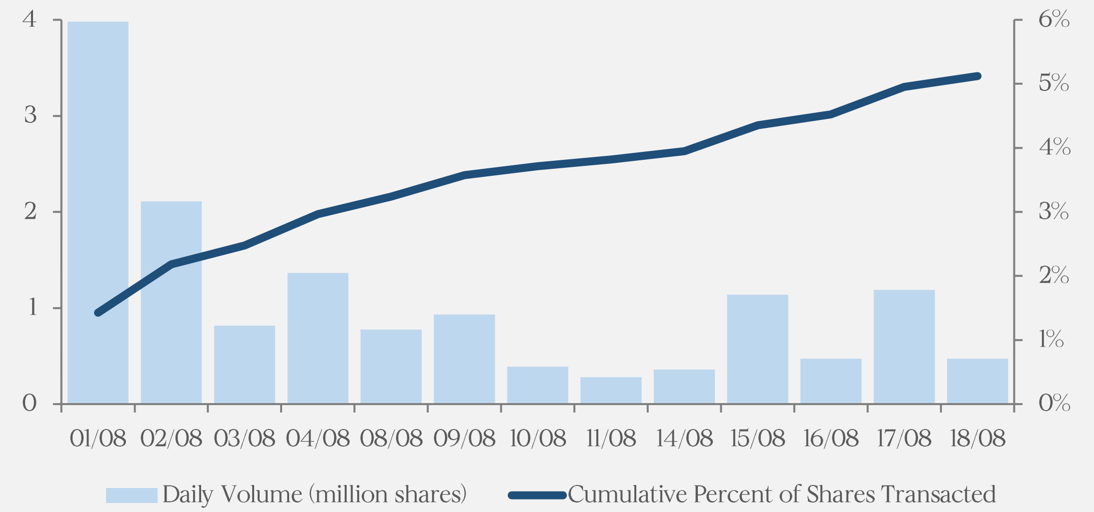
Historically, shareholder activism has been targeted towards companies with good assets, but a management team operating them poorly. Typically fighting for board seats, the only recent campaign that acted to block a proposed transaction was Horizon Partners movement to persuade shareholders to vote against TransGlobe's all stock sale to Vaalco Energy. Ultimately, Vaalco was successful in their bid for TransGlobe.

We see this Waterous transaction as solving the Pipestone governance issues that came with their large private equity positions. Retail owners were indeed treated like minority shareholders, while the pro-forma Strathcona entity will certainly have issues of its own, we believe governance will not be one. Pipestone shareholders will still participate in growth that happens on their current Montney assets – though risk of delination failures are much less of a concern, given the large existing Strathcona production base. While Pipestone shareholders would be correct to raise concerns about growth and valuation being diluted in a larger entity (as Bison did) – we model pro-forma Strathcona DAPPS growth through 2024-2026 of 17%, 15%, and 14% sequentially, with excess free cashflow, above incremental growth allocated to cancelling shares. Strathcona is a mature business, whereas Pipestone was still meandering through their growth phase, a similar situation to the TransGlobe/Vaalco deal.

In this case, Pipestone is held tightly by a number of institutions, which makes activism much harder. Without flipping the large blocks held by GMT, or Al Mehwar Investments (a family office in the Middle East) – there is virtually no hope for an activist to block this transaction.

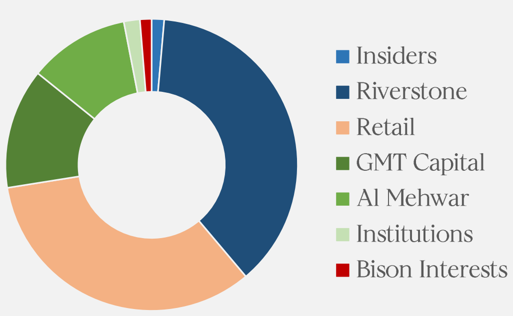
While Bison is a private fund that does not disclose AUM on a regular basis, HTM estimates an AUM of $115m, and a position in Pipestone of approximately $8m (6.5% of AUM). While significant for Bison, it represents 1.2% of Pipestone's current market capitalization. Since the deal announcement, Pipestone has only traded ~5% of its shares oustanding. Per Canada's Business Corporations Act *"the holders of not less than five per cent of the issued shares of a corporation... may requisition the directors to call a meeting of shareholders for the purposes stated in the requisition"* (c. C-44, s. 143). We don't believe it's possible that Bison has the required holdings to call a meeting, though may petition another large holder to. While Riverstone has entered into a voting support agreement with Strathcona (representing ~40% of shares outstanding), GMT and Al Mehwar haven't, leaving ~25% of the shares outstanding, between two entities. Given that this transaction would require a supermajority vote for approval, should Bison garner support from both GMT, and Al Melwar, there's a chance that they may be successful in blocking the transaction with its current terms. Without flipping one of the two 'undecided' blocks, Bison will likely be unsuccessful in their pursuit.

(Fig. 3) Pipestone Post-Announcement Volume



Source: Bloomberg, HTM Analysis

(Fig. 4) Pipestone Ownership



Source: Bloomberg, HTM Analysis

Of course, there is then the disucssion about what happens should an activist be successful in convincing current Pipestone shareholders that the Strathcona transaction is not in their best interest.

The unspoken basis of this transaction was Waterous Energy Fund (of which, Strathcona Resources is their single portfolio company) seeking a public market for their current LPs to access liquidity in. If their Pipestone bid is successful, they will have provided just that. Though, given their short timeline, and in general, companies in better positions than when WEF began their acquisition spree in 2017 – there were only a handful of potential candidates that would provide WEF that liquidity.

While Pipestone's assets are complementary to Strathcona's current portfolio, we don't believe that Pipestone was their first choice to go public. We think the biggest risk to an activism campaign is rooted in the exhaustion, or indifference of parties on both sides of the deal. On Pipestone's side, management has continued to dissapoint, sure, Pipestone ***could*** be worth more as a standalone company, and while rumors of interested parties last year circulated, according to management, they reviewed multiple transaction opportunities and decided a deal with WEF was the best for current shareholders – implying the absense of better transactions. Given the continued failure of Pipestone management, we don't believe that shareholders would be supportive of the entity continuing to exist in its current form, given the Waterous bid. We believe that Bison will lobby for an amended share exchange ratio that gives an increased ownership in the pro-forma entity (shown in fig. 5). While the number of shares outstanding would remain at ~214m, current Pipestone shareholders would own ~42% more, or 12.5% of the pro-forma equity (note, these are HTM estimates, as Bison has not disclosed their plan). While Bison cites Pipestone is undervalued among peers, we think the correct peer group is a list of SMIDs without clear direction, or those that have only recently inflected in terms of "corporate identity" – among those producers, Pipestone's implied takeover valuation is quite fair, in line with peers, including another Alberta-focused unconventional gas producer Kiwetinohk. Kelt and Crew, which both trade a multiple point higher than Pipestone have clear stories, plans, and direction. Thus, we believe that the Pipestone valuation at announcement was more the fair. Yes, we absolutely believe that Pipestone had upside when delineation results were released – though the Strathcona transaction offers an immediate 'step-down' in risk profile, along with better governance, a better commodity mix, and a deal better than other options. The ever-lingering question for a private equity backed E&P is when they will access liquidity. While the Strathcona deal doesn't provide that exactly (and the fact other WEF LPs will be simultaneously seeking liquidity is less than ideal), there is no guarantee Pipestone would see another deal with better terms from another bidder. While from WEF's perspective, agreement to a different share exchange ratio would be immaterial on a dollar value basis, they would be delivering a 3.3x MOIC at today's market value, compared to a 4.0x MOIC as implied on July 31st when the deal was announced – a haircut we don't think that WEF would like to take. The time for a Pipestone shareholder to go

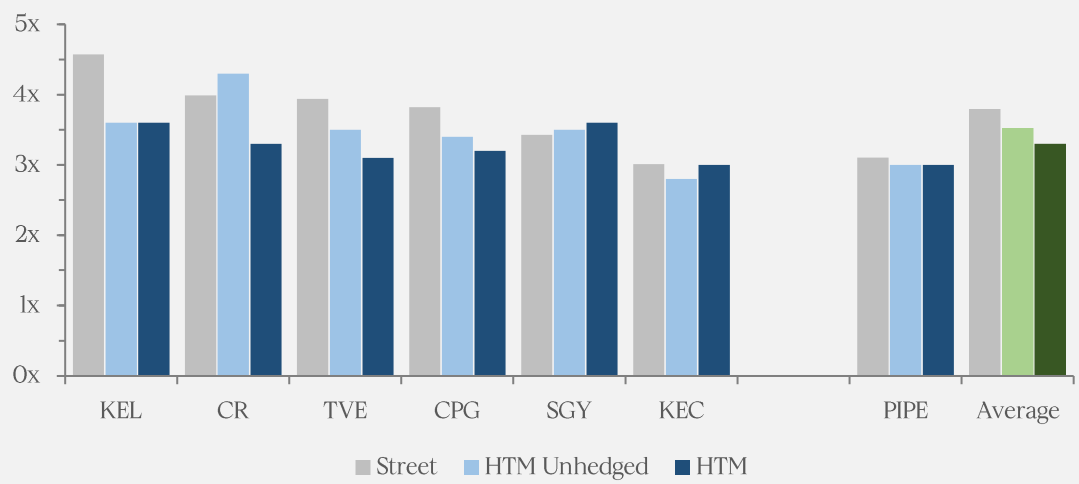
(Fig. 5) Estimated Bison Proposed Exchange Ratios

Current	Current Shares Out	Exchange Ratio	AmalCo Shares	% Ownership
Strathcona	2,186,705,444	0.089	195,224,689	**91.13%**
Pipestone	279,708,062	0.068	19,010,918	**8.87%**
AmalCo Total			214,235,606	100%

Proposed	Current Shares Out	Exchange Ratio	AmalCo Shares	% Ownership
Strathcona	2,186,705,444	0.086	188,056,668	**87.51%**
Pipestone	279,708,062	0.096	26,851,974	**12.49%**
AmalCo Total			214,908,642	100%

Source: Company Reports, HTM Analysis

(Fig. 6) Pipestone Peer EV/DACF Multiples



Source: Company Reports, HTM Analysis

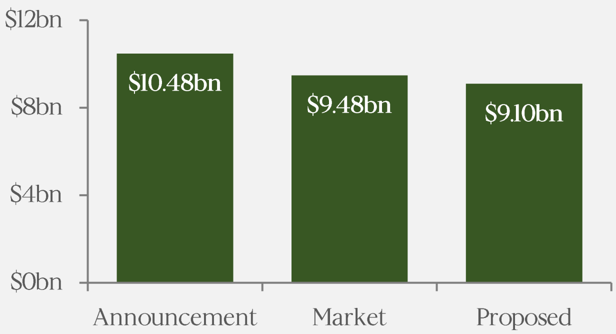
(Fig. 7) WEF LP MOIC

	PR	Market
Original	4.0x	3.5x
Proposed	3.8x	3.3x

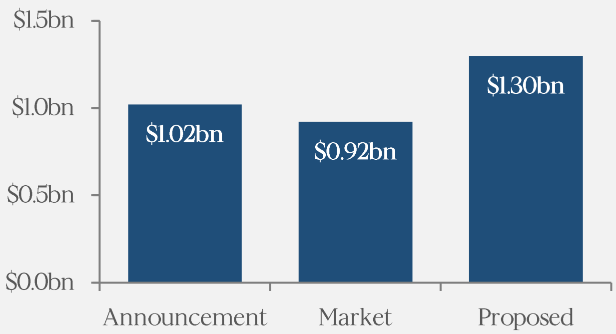
Source: HTM Analysis

activist was months ago, before a deal was even on the table – after they telegraphed intentions of a buyback that never happened, when the stock was -60% from 2022 highs. Both the 2022 bids, and the Strathcona bid were well rumored – we believe the window for an activist is closed. Today, the deal break fee is only $25m – should another party want to make a bid for Pipestone (*if it wasn't already marketed*) it would be completely insignificant to pay. Two takeaways from that – Waterous isn't desperate for Pipestone, and no other bidders have come forward.

(Fig. 8) Strathcona Implied EV



(Fig. 9) Pipestone Implied EV

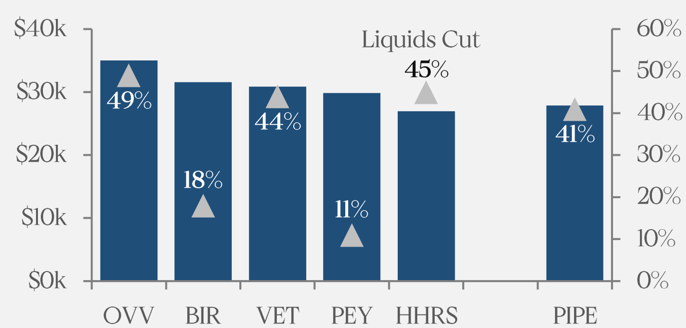


Source: FactSet, HTM Analysis

While the Bison proposed takeover EV would likely be ~$1.3bn (shown in fig. 8 and fig. 9), the new Strathcona EV, at market, would be just over $9bn, down from $10.5bn at deal announcement. Though, yes, this deal could indeed be construed as unfair to existing shareholders, the market for Pipestone is narrow, and quiet (clearly). While the cited comparable transactions by Bison include Athabasca and Murphy's sale to a private buyer in the Duvernay (Cygnet Energy, an ARC Financial backed private E&P), the land transacted is significantly better than Pipestone's assets. Given Pipestone's drier, more sour, and geographically challenged production (they will always be last place in the infrastructure line), they certainly deserve a discount.

Really, when it comes down to it, Pipestone isn't an ideal acquisition. Sure, it's cheap, but that's why Strathcona is interested. If you remove the "cheap" part of the deal, there isn't a lot of reason to consummate the transaction. When you compare it on an EV/BOE/d basis to peers (shown in fig. 10), it fits somewhere between a totally dry gas producer (Peyto), a troubled Montney producer (Birchcliff), and a confused liquids name (Ovintiv). For all its flaws, Pipestone appears to be priced right. Remove the attractive pricing, and you remove the real motivation for Strathcona to transact. The large Pipestone holders know that, and if they risk throwing the deal, they risk another long wait for hope for liquidity.

(Fig. 10) Implied EV/BOE/d at Deal PR



Source: Bloomberg, Company Reports, HTM Analysis

This, coupled with an activist campaign by Bison, that, as it appears now is entirely hosted on Twitter – with no disclosed position size, or letter sent to either company, tells us, that Bison is perhaps tepid, or unserious with this undertaking. Given that <5% of the company has traded on the exchange since deal announcement, we find it unlikely that Bison has any meaningful position. Referring to the list of recent TSX activist campaigns (fig. 2), the average ownership position was 8.9%, while we estimate Bison owns 1.2% of Pipestone. The only activist campaign with ownership that low was Cation Capital's push to nominate 4 Crescent Point board members – a motion that ultimately failed, with zero members elected. We don't believe that Bison will be successful in their pursuit.

The only opportunity for Bison to garner support is through Al Mehwar Commercial Investments, which is a family office headquartered in the Middle East with ~$300m in AUM. Pipestone Energy is their only energy holding (surviving from the Canadian Non-Operated Resources distribution) and 20% of their portfolio weight. Al Mehwar's current Pipestone cost basis is below today's price, and the current proposed transaction would, given their holding style, not only fit their portfolio better, but crystalize a win after an almost round trip on the stock.

GMT Capital owns just shy of 15%, and we believe it to be unlikely they would move offside from the proposed Strathcona offer. While Strathcona doesn't fit exactly in their portfolio makeup (weighted towards juniors), Pipestone is a small position at <2%, and, given the management structure, Pipestone has one GMT appointed board member. Note, that all management, and board members have given approval to the transaction.

We do not see Riverstone deviating from their letter of support. While Al Mehwar, and GMT both have not signed formal letters of support, we posit that any Bison proposed arrangement would not be enticing enough to side with. The HTM estimated exchange ratio would only represent a 27% higher offer than the $2.72/sh the Strathcona transaction was announced at. We believe that GMT and Al Mehwar are/were both waiting for an alternative cash offer (catalyzed by the Strathcona offer), and hence the formal letter of support. Given that Bison will likely propose an increased ownership in the pro-forma entity, we don't think that both holdouts will view it as interesting enough to possibly throw the deal and lose the offer. Pipestone governance is poor, and they are generally worse operators than Strathcona, even if they are not top decile industry operators – on a long-term IRR basis, shareholders are likely better with the Strathcona team, and we believe large institutional holders will recognize that under current leadership their "on-paper" net asset value will never be realized.

The transaction market is fundamentally different from when Waterous Energy Fund was launched in 2017 – and Pipestone is one of the last remaining "cheap" assets. We believe if there is significant reason to, Strathcona will seek alternative pathways to liquidity, and abandon the Pipestone deal all together, rather, bidding for an asset that they want, and paying more if needed. In our opinion, paying more for Pipestone would move the deal from value territory, and into fair market value pricing. Given that we don't believe Strathcona to buy something that doesn't offer value, regardless of liquidity goals, we don't see support for a higher exchange ratio that Bison may propose.

Given Bison's size, and their current expertise, we believe the best opportunities for successful activism are small E&Ps with little direction, and perhaps poor execution and guidance. We believe Bison would be most successful targeting largely retail owned names with sub-$200m market capitalizations. Razor Energy is a good example of a target in Bison's league, and a current Bison holding. We believe we will see this from Bison in the future, and launching a Twitter-based campaign against Pipestone will be the jumping off point for appropriate activism in the future. There is little downside, if Bison cannot easily flip one of the two holdouts, they can still market their willingness to "stand up for the little guy" – thus we believe this campaign to be mostly for optics.

Executive Summary

While activism in oil and gas has been lacking in recent years – we believe this to be a function of overall better governance. The activist campaign launched by Bison, towards Strathcona/Pipestone we believe will not materially alter the course of the proposed amalgamation deal, and believe the exchange ratio currently proposed to be fair, given the past performance of Pipestone, and appropriate market comps.