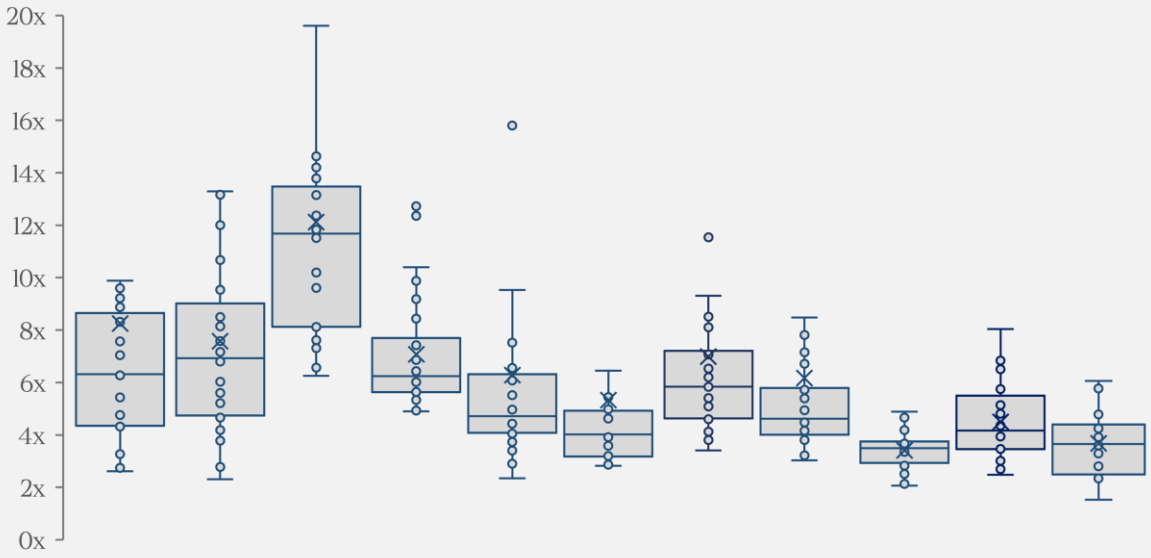
Weekend Alternative Narrative

The Low Multiple Myth - September 2nd, 2023

There are very few good businesses with low multiples, buying a good business means paying more, and good businesses are more desirable to future shareholders (who tend to pay more too), and more likely to see positive total shareholders returns - so buy the good businesses. There, note finished - point made. Have a great long weekend. While we wish it was that easy, unfortunately it isn't (well, the buying good businesses part is easy when you know what to look for, the explaining it, and looking for them part - not so much), and there's more nuance, and more factors than just "multiple" or "free cashflow" that make up a quality E&P. Most of it is more qualitative than quantitative, and really, the majority of "what makes a good E&P" boils down to four things - smart management, wide margins/little bloat, solid access to willing capital (and smart capital management), and a quality asset - and most importantly - an understanding of why the opportunity and/or company exists. Strong margins attract capital, smart management can find good assets, good assets find their way into the hands of those with capital - all these factors generally exist to some extent in good organizations or will come to exist with time.

So, while yes, it's true that multiples have come down (see fig. 1), the ability to take advantage of the lack of spread between good companies, and bad companies, seems to be the opportunity, rather than the buy-in-large sector "cheapness", especially if you pay attention, in any form, to the risk you're taking when purchasing energy equities. Yes, the sector is cheap, but "cheap" within energy, doesn't necessarily mean safety, or a good buy.

(Fig. 1) 2014-2024E Canadian E&P EV/DACF Multiple Dispersion



Source: Bloomberg, Company Reports, HTM Analysis

Daily Pricing & Week on Week Benchmark Chg.

CAD Priced Liquids

Condy | **$112.45** (+6.9%)
Synthetic | **$120.77** (+8.3%)
WCS | **$91.08** (+10.4%)

USD Priced Liquids

Bonny Lt. | **$91.80** (+2.7%)
LLS | **$87.85** (+4.7%)
MEH | **$86.95** (+5.4%)
NYMEX | **$85.55** (+7.2%)
WTI FOB | **$80.65** (+0.2%)

CAD Priced Gas

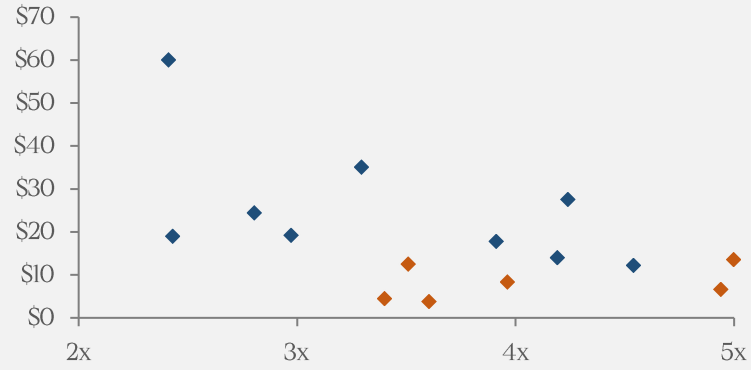
AECO | **$2.77** (+5.0%)
Alliance | **$2.86** (+8.1%)
Empress | **$2.65** (+5.2%)
Station 2 | **$2.29** (+0.2%)

USD Priced Gas

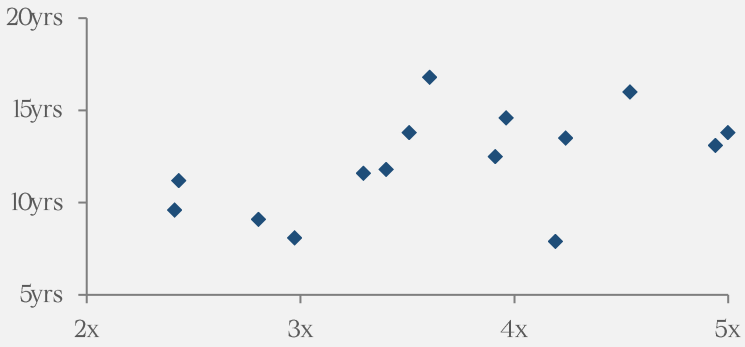
Dawn | **$2.31** (+8.2%)
Houston | **$2.51** (+6.6%)
Malin | $2.45 (-14.3%)
PG&E | **$3.63** (-17.1%)
SoCal | **$3.20** (-30.4%)
Waha | **$2.13** (+6.8%)

The cost of adding barrels, both on the market (acquiring), and organically, is an often-undiscussed factor, especially the "A" part of FD&A. If you believe in any sort of reserves carry trade, or an active M&A market, the cost of adding a barrel into your 2P reserves should be top of mind. Ultimately, your FD&A costs filter into your recycle ratio (the ability at which you can replace reserves profitably), and your recycle ratio filters into, well, value creation. On the left of fig. 2 you have liquids producers (in blue) like Baytex, Tamarack, and Obsidian who see a material multiple discount to peers like Enerplus, and Whitecap on the right. If you can't add barrels into reserves effectively, or pay too much to add them, your margins suffer and you eliminate the full-cycle margin of safety that lower-cost peers enjoy. Take Baytex for example, with a 3yr average PDP FD&A of $15/boe, proved at $31/boe, and 2P at $33/boe – while reserve revisions may help that, really, economic additions should be ignored as it's not value created by management – thus, to continue to produce "profitably", Baytex needs a $30/bbl netback. Either lower field costs, or higher oil prices help this – and for reference, their 2022 netback was ~$40/bbl, with 2021's netback being ~$30/bbl. In the commodity space, being on the knife's edge between an outfit that's creating value, and destroying value is tough to own – and hence, people are hesitant to pay more (multiple wise) – and thus Baytex becomes a bet on one of two things – management inflection (can they improve costs/operations enough to give themselves a margin of safety), or, on the commodity moving sustainably higher, *permanently*. Both are valid reasons to want to own Baytex, especially given the appointment of a new CEO, but the market has certainly decided they aren't going to extend credit, and thus, Baytex' 2024E EV/EBITDA has fallen from 4x in 2022, to 2.3x YTD. Could Baytex see a 5x multiple in the future – sure, but it doesn't just "deserve" one, and at current, it feels to be priced right, *for what it is* – a company with thin margins, that may not be earning their cost of capital. So, you're betting on a turnaround – if you believe that will happen – then Baytex is cheap – though in a historical steady state – there's a strong argument to be made they are priced correctly.

(Fig. 2) 2023E EV/DACF vs. 2022 2P FD&A



(Fig. 3) 2023E EV/DACF vs. Risked Development

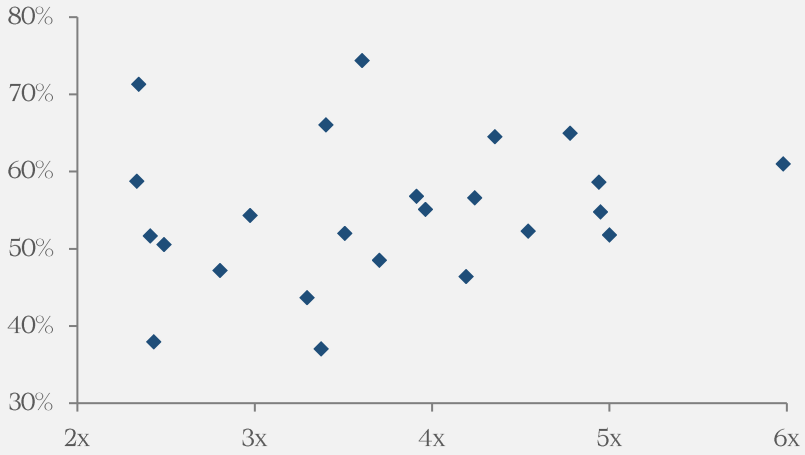


Source: Bloomberg, Company Reports, FactSet, HTM Analysis

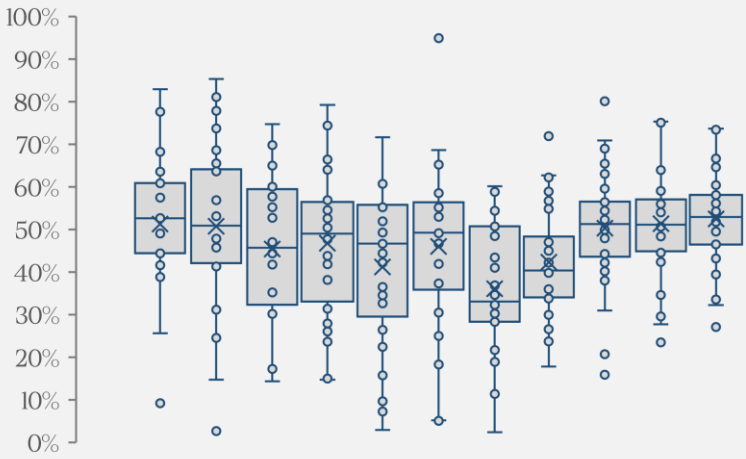
Naturally, there's also a correlation between your risked development life, and your multiple. Of course, the market tends to pay forward when there are decades, or more, of development that shareholders can be reasonably confident will happen – if you are light on inventory, or its cost structure isn't attractive, naturally your multiple suffers. If you are a MEG, Cenovus, or Athabasca, you can justify paying for decades of highly likely economic reserves, if you are a Cardinal, Obsidian, or Baytex – then the market pays less. Again, if you think that Obsidian will expand their reserves base through exploration, then it's cheap – but you are betting on the clear expansion of reserves as a catalyst, because, given the information the market has, it's priced in line with peers given the RLI.

The market, today, and historically, has favored low-cost producers, and typically high-cost producers tend to have lower multiples – yes, they offer the fabled "torque" – but with great torque, comes a great discount on your equity multiple. Logically it makes sense, if forward volatility is expected, and your earnings may be negative 3 of 5 years, you really aren't going to confidently pay for more than 2 years – thus the correlation between forward volatility expectations and multiples, and while volatility softening is bullish, it's a tailwind for really every name in the sector. More importantly, if your margins aren't fat enough to protect you from slides in commodity prices, then logically, people don't pay up. Names like Tamarack work on their margins, and thus should earn a higher multiple for that, but as previously mentioned, lose points for their, at times, seemingly less-than-strategic acquisitions. Thus, Tamarack is cheap if you believe they are finally settled into a resource play they will develop for the rest of their corporate future, eventually the market should pay more for the equity – but that needs to be seen, and you're noy buying a "cheap stock" if they don't, you're taking on the risk they decide that the Horn River is the place to be in 2024 and pay up for land in the play.

(Fig. 4) 2024E EV/DACF vs. NTM Cashflow Margin



(Fig. 5) 2014-2024E E&P Margin Dispersion

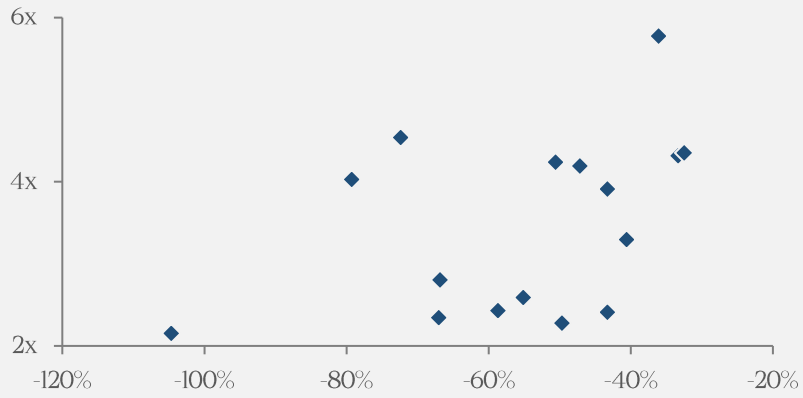


Source: Bloomberg, Company Reports, FactSet, HTM Analysis

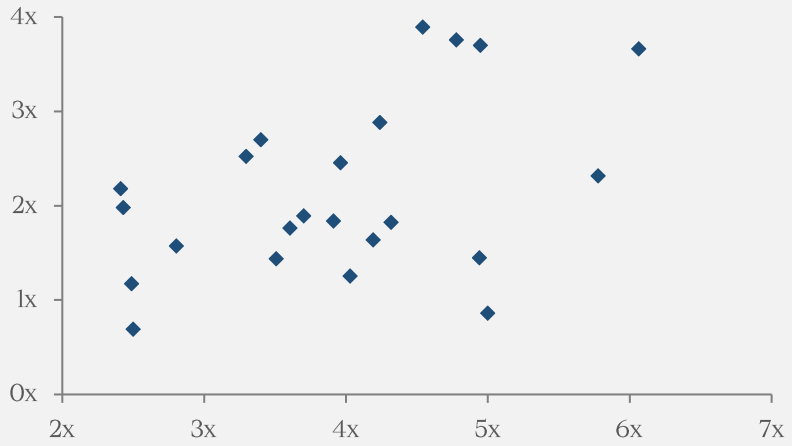
Acquisitions are tough, and usually, you pay a lot of the barrels (recall, that's built into your 2P FD&A cost), so if you can't acquire cheap, you have thin margins on production, and thus, a lower multiple (yeah, it all does chain together, surprisingly). If you think Tamarack shakes their history of acquiring, and focuses on the many good things they do, then 3x EV/EBITDA is a steal, all things considered, but again, as of right now, they aren't necessarily cheap. On the flip side, should resource plays companies have built an infrastructure position in, like Hammerhead see a higher multiple, likely – and there's the differentiation. Hammerhead may be considered cheap at 5x, while Baytex could be considered wildly expensive at 5x – there isn't just one "multiple" that dictates a good deal. Historically, cashflow margins (shown in fig. 5) have hovered around 50% – with lower margin producers earning a lower multiple. There is nothing different about this cycle. The quality of the business dictates the multiple – if you have a low-quality business, you deserve a lower multiple. Because it looks cheap, doesn't mean it's cheap *compared* (and they key here, is relative) to peers. Owning low quality E&Ps, in our opinion, is simply buying a call option on oil with a consistent linear management decay – you wouldn't pay much for an OTM call in the futures market, and you shouldn't pay much for an OTM call option in the equities market. If you believe though, that the story management is pitching, is believable, and executable – then there is relative value to peers – but buying cheap names doesn't mean alpha.

Of course, low margin means high torque – which is what people may be after (and while you'd likely be better off buying the commodity, that's a discussion for another day), but at that point, you're likely not chasing multiple expansion, so much as you're chasing higher commodity prices, and if the higher prices don't come, you're suck holding a company that's probably not actively creating value. If a -$20 move in WTI effectively erases your free cashflow, then you are likely to be stuck in low-multiple-purgatory until you can improve your business, but a better business doesn't mean a bigger business. There are too many examples of acquisitions that add barrels, but don't do anything to further strategic goals. Now, there is an opportunity where the long term strategic goal may not be clear, but, you are then betting the jockey (management) not the horse. Here's where corporate costs (and scale) play a big role – if you can actively replace production 1:1, but it costs you $10/bbl at the corporate level, management is just paying themselves to tread water. G&A, transaction costs, and interest expenses are all real costs that stand between a dollar from the sale of oil, and a dollar to the shareholder, and lower multiple, lower quality companies tend to have high corporate costs.

(Fig. 6) 2024E DAFCF Yield Sensitivity to $65 WTI



(Fig. 7) 2024E EV/DACF vs. ROIIC:WACC Ratio

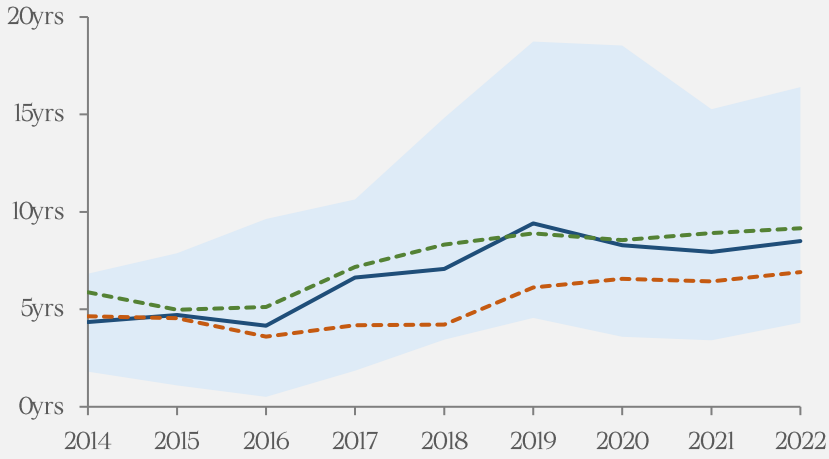


Source: Bloomberg, Company Reports, FactSet, HTM Analysis

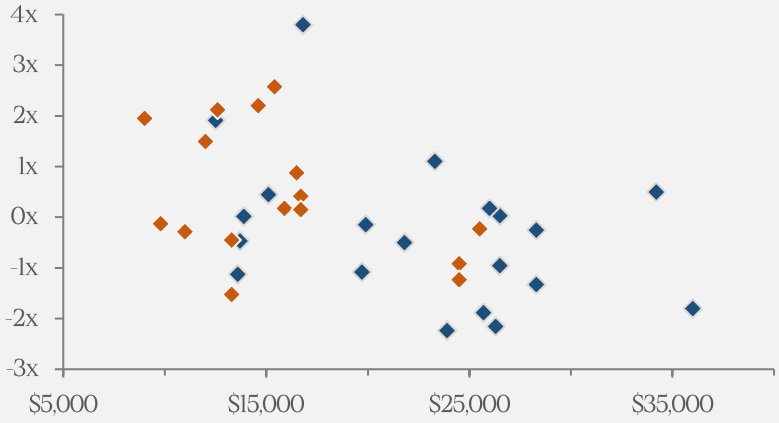
Lower margins, also, typically means lower return on incremental capital invested, and if an E&P is barely earning their cost of capital and not growing profitably, there's again no reason to bet on them, so we come back, again, to the opportunities that E&Ps have to invest in their asset base. If you have a high return set of opportunities, and management that can effectively steward those – you guessed it, your equity multiple is higher. If you have a questionable set of opportunities that is mostly linked to the price of the commodity – lower multiple. The notable phenomenon in fig. 7, is the companies on the top right of the chart, who have a high return asset base, and the ability to scale that, from cashflow, profitably – earn the highest multiple, as *they should* – profitable growth deserves a higher multiple, and on an out-year basis, they tend to be just as "cheap" as the low-growth less-profitable businesses that aren't growing. Logically – what is more ownable – a company that makes a lot of money at $90, almost no money at $60, has a high cost structure, and grows through acquisitions that don't make a lot of sense, and has a history of -5%/yr of earnings decay on a flat price deck, or, a company that can make money down to $50, reinvest earnings into new projects, and double per share earnings in 8 years on a flat price deck. You'd be right if you said the second is more ownable, and of course, the second sees a higher multiple. You'd never pay as much for the first company – it's just oil price beta, and if that's what you're after power to you, it doesn't mean it's cheap.

Harking back to the asset life idea – the same goes for terminal value of an asset. ARO is a real thing, especially in a post-Redwater industry. If you don't have a handle on your ARO, you are guaranteed to have a high cost of capital, and, almost no access to incremental capital – one of the four important qualitative factors. If you are laden with decommissioning liability, different from 2010-2014 – the window in which you need to abandon your assets is much, much closer. So, when you look at the number of years of reserves you "get for free", which we define as your unrisked development life, minus your multiple, and adjusted for a market appropriate ARO (not the reported ARO, which in many cases is understated), lower quality names (shown in orange, in fig. 8) are giving you fewer "years for free" than their higher quality peers (shown in green). Double that with a cost of capital that is lower among the higher quality names (i.e. a higher NPV of "free" reserves) and the value proposition to simply buy quality again, makes itself apparent. The argument should be made you should pay for fewer years among the lower quality names than you should the higher quality names. Of course the trend that the better names effectively acquire, and attract exploration talent mean you could also underwrite more durable reserves per share expansion among the higher quality names (hence, they are earning their multiple). Again, we reiterate – cheap doesn't mean there is value. If you high a high cost to add barrels, a high cost of capital, an inefficient operation, and a general history of irresponsibility – it's safe to say that you should mainly be thought of as a proxy for oil price beta – and if the price of oil, down strip, hasn't moved durably in the past 2 years of volatility, why should your valuation move (again, we aren't sure that low-margin barrels are going to be in the money in 3 years, so why pay more for them). If you want to then, take a bet on the price of crude being $90/bbl in 2027, there feel like better options out there, where you're not paying for corporate, and lifting costs. If you're no growth, and your 2025E free cashflow multiple is 40% higher than your 2023E multiple, and you can't profitably grow – is your equity really cheap?

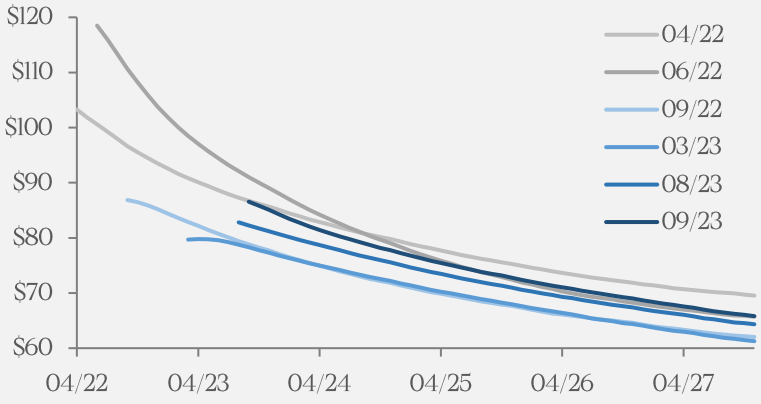
(Fig. 8) ARO Adjusted "Reserve Years for Free"



(Fig. 9) Efficiency vs. Distance to Peer 2024E EV/DACF



(Fig. 10) WTI Futures Curve Progression



Source: Bloomberg, Company Reports, FactSet, HTM Analysis

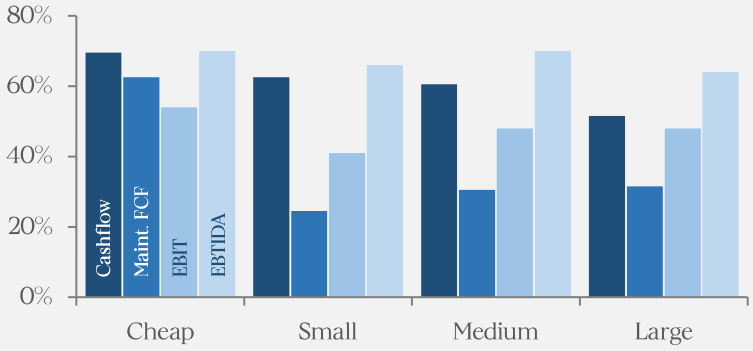
With all that said – there is a subset of small/low multiple businesses that generally excel at factors that other small, lesser quality names do poorly. We believe that size, and liquidity are valid reasons for multiple discounts, though if it is the only reason, there is still the ability to realize value if you have an outstanding management team, or, you simply have an absolute return vehicle where you can clip a sustainable yield. There are three hold type portfolios you can construct and compare, to drive the point home that small doesn't equal cheap, and cheap doesn't equal bad (though, for the most part, it mostly does.

"Cheap" – HME and LOU
"Small" – OBE, SGY, and TVE
"Medium" – CPG and WCP
"Large" – CNQ and TOU

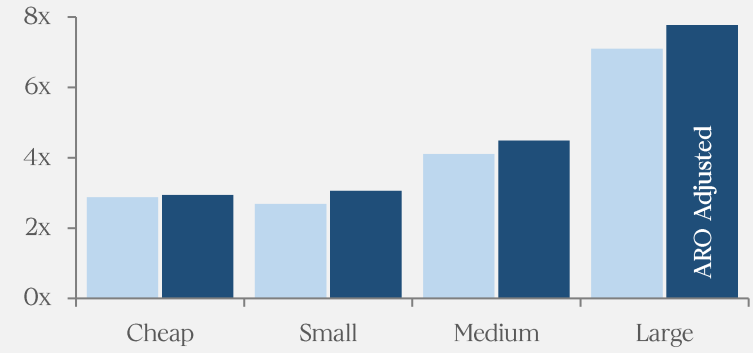
While the "cheap" names are indeed small, they have better margins, lower finding and development costs, a higher ROIC:WACC ratio, and a more sustainable capital structure than the "small" companies. For the same multiple. Hence, the quality differentiation that needs to be done if you want to own "small" names. Not all small cap companies that sell for 2-3x EV/DACF are cheap – in fact, there are very few of them that are actually cheap.

We highlight a few of the factors in the charts to the right that differentiate the "cheap" names from the "small" names (note "cheap" = cheap & high quality, and "small" = cheap & of questionably quality) – mainly the higher grade issuers that just happen to be small, having attributes akin to much larger shops, with a much lower multiple. While it would be naïve to say that the cheap issuers we have selected don't come with their own set of hurdles, like true inventory depth (recall Crescent Point was seen as mostly inferior due to lack of inventory through 2022, though solved it with the acquisition of Spartan Delta), the idea we proposed in the beginning, that strong management, and access to capital will solve that – still stands. If you truly trust a management team (which is the first priority in the business, we'd reckon), either inventory life is solved in a way that is beneficial to shareholders (and likely sees the multiple expand), or value is crystalized via transaction (as seen with Lucero's sale of their Bakken working interest asset).

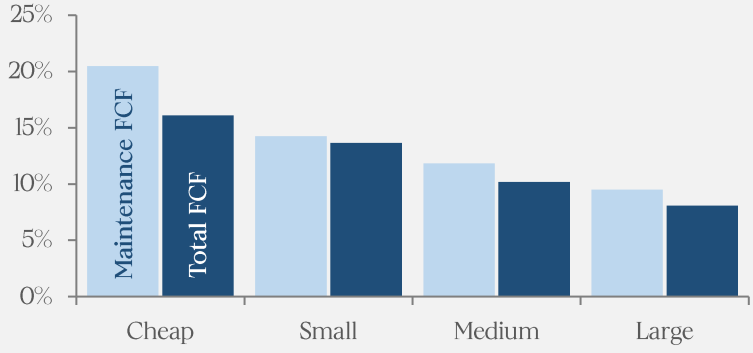
(Fig 11.1) Margins by Hold Type



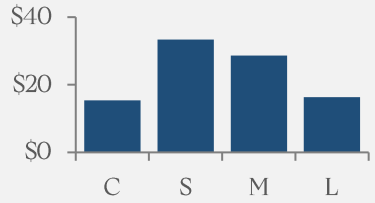
(Fig 11.2) 2024E EV/DACF by Hold Type



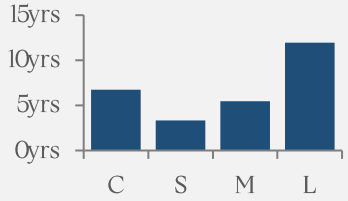
(Fig 11.3) 2024E DAFCF Yield by Hold Type



EV/PD BOE



PD RLI



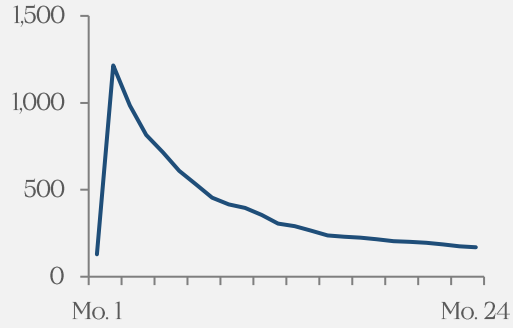
Source: Bloomberg, Company Reports, HTM Analysis

While Lucero is small – it's also cheap, and shouldn't be. Management is strong, with a respectable track record (their incredible 1H23 asset disposition only goes to confirm that), and they have private equity capital backing. Lucero has used their equity effectively – and importantly, for a small cap, have a low corporate cost structure (with G&A <$2/BOE, which eclipses peers in their size bracket, and is competitive with larger, at scale names like CPG, HWX, and MEG), and a simple asset. When you buy Lucero, you're buying 30 drilling locations in the core of the North Dakota Bakken, with a competent team running the outfit, access to capital, and high margin production, with a simple story – trading for a lower multiple than peers that are "cheap", *but rightfully cheap*. You don't take on the same corporate risk, and the same execution risk that a company with multiple core areas has.

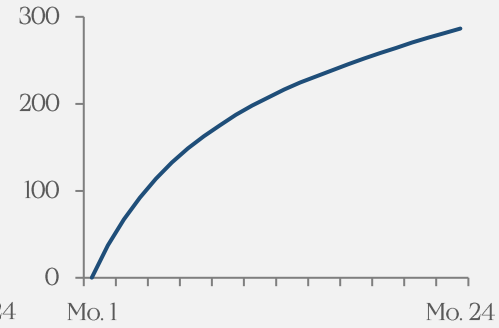
At $85 WTI, and 5% inflation you own your share of 32 locations, worth $12.6m each (as modeled on NPV_{20} by HTM) for a total of $400m, along with the PDP blowdown NPV_{20} of $150m after abandonment, and $80m of working capital. A conservative present value of $630m at a $415m market cap – and importantly, competent management that has been responsible with the share count in the past, and good stewards of capital – that is rare.

Trading below SOTP doesn't always mean value (take Zargon for example, they traded at blowdown value in 2013, but it was low margin production, and they were too levered, Lucero has no debt), but a smart, and aligned management team with successful exits works to mitigate that. Really, companies like this shouldn't be public (and for the most part, they aren't, take Mediterra, Storm, or Spur for example) – but it is, and it's cheap because it's small, listed on the TSX while being a US operator, and trades generally thin. Those are reasons that management can fix, and can usually fix accretively. If Brett Herman and his team don't work to crystalize value for shareholders through a sale, they will work to create value otherwise. Part of the business is knowing when to fold them and lock in the IRR you have on the books. If they don't sell, a follow on is likely, and we believe that if Lucero decides to transact, it will be positive for shareholders.

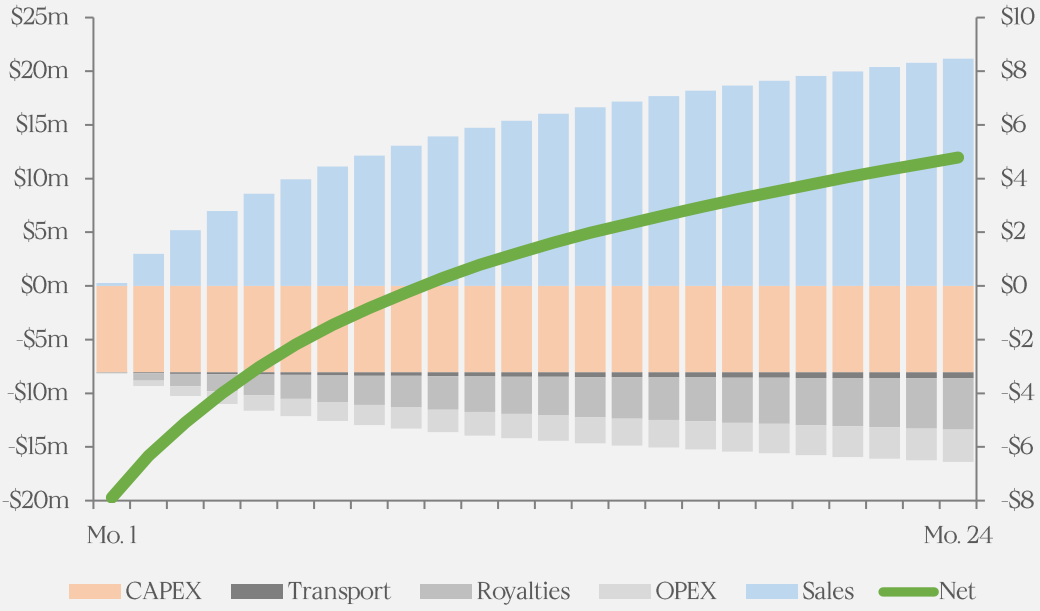
(Fig 12.1) Lucero Type Curve



(Fig. 12.2) Cumulative Production



(Fig. 12.3) Illustrative Lucero Three Forks Well Economics



Source: Company Reports, Enverus, HTM Analysis

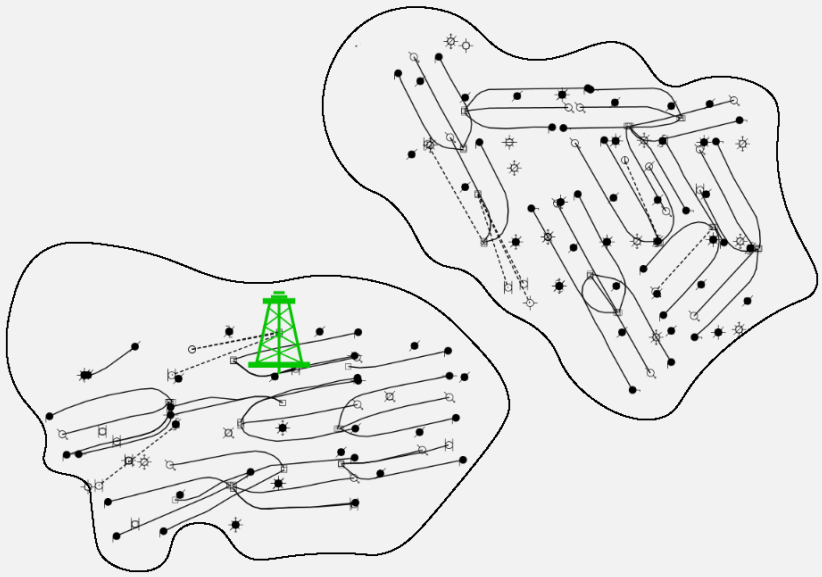
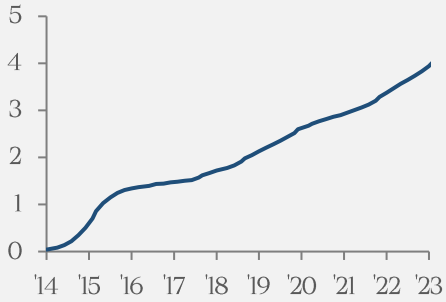


Fig 13.1: Diagram of Hemisphere Energy Atlee Buffalo Mannville pools

(Fig. 13.2) Production per Day

(Fig. 13.3) Total Production



Source: Company Reports, geoLOGIC Systems, HTM Analysis
Note: Production per day shown as kbbl/d, and total production shown as mbbl

Also in the "cheap but simple" category is HME, who's main, and really only producing asset is a set of adjacent Mannville pools in southern Alberta. If you compare Hemisphere, to say Surge, who also targets a sizeable amount of Manville production – the corporate cost structure, and execution risk is sizably different (with Surge having a more questionable track record) - for equally inexpensive producers.

At $85 WTI and -$15 WCS, for $125m on the market, you can own what HTM models as PDP blowdown NPV_{20} of $130m after abandonments, with $90m of further upside from the PUD and probable reserves, $10m of working capital, and the potential development of a new core area on land acquired YTD (note, that their current asset was purchased for $500k in 2014).

While Hemisphere has flirted with debt, they don't currently have any, and are returning free cashflow to shareholders through a buyback, and an implied 8% dividend. Hemisphere is a simple operation, and at a 40% discount to an already rigorous SOTP valuation, there is a reasonable margin for error, where even with no incremental value created (infact, we would go so far to underwrite value destruction), we are okay owning it as an absolute return vehicle. YTD, Hemisphere has had to whipstock a well (essentially retry the lateral), and why they successfully drilled and cased the lateral in August – there is no reason to underwrite any significant value creation here for the valuation to still be attractive. Though the team is technically experienced (in the field), they have been responsible with the share count, and kept corporate costs reasonable – there is enough margin in the value proposition that they could stagnate on a per share growth basis (though we see strong growth potential, and importantly, funded from cashflow), and it wouldn't be the end of the world, especially compared to the typically cheap names who tend not to grow on a debt adjusted per share basis.

Overall, we believe that seeking out low multiple names is a fair way to play an oil cycle, especially if you take a secular view on higher prices, and are okay with day-to-day volatility, but overwhelmingly so, we see more long term value in looking at holistic factors first, to judge the quality and growth potential, then visiting relative valuations.